19 April 1999

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

Dear Dr Preston

BCA/CTA SUBMISSION ON *A PLATFORM FOR CONSULTATION*

The Business Council of Australia (BCA) and the Corporate Tax Association (CTA) have taken a keen interest in the tax reform debate a welcome the opportunity to make this submission to the Review of Business Taxation. We view business tax reform as a vital component an integrated approach to the much-needed rebuilding of the tax system. We congratulate the government for its leadership in taking up tl critical challenges presented by our current tax arrangements.

Both bodies are members of the Business Coalition for Tax Reform and support its objectives for reform:

> to improve international competitiveness and fairness in taxation and to contribute to a climate favourable for investment, job creation and saving.

The Business Council of Australia was established in 1983 by merger of the Business Round Table and the Australian Industries Development Association. It provides a forum for over 100 of the chief executives of Australia's largest companies to contribute directly public policy formulation in Australia.

The Corporate Tax Association is the key representative tax body for Australia's major companies with a membership of 107. With its members involved in practical corporate tax issues on a day to day basis it is well placed to represent the views of business on these issue

As there is significant overlap in our membership the CTA and the BCA have decided to provide a joint submission to avoid unnecessary duplication.

The submission sets out the broad thrust of the results of our discussions over the period since 22 February 1999 when *A Platform for Consultation* was released. The supporting material attached provides greater detail on specific policy areas.

Yours sincerely

Romano Nenna
President
Corporate Tax Association

Campbell Anderson
President
Business Council of Australia

BUSINESS
COUNCIL OF
AUSTRALIA

Business Council of Australia

Corporate Tax Association

JOINT SUBMISSION ON *A PLATFORM FOR CONSULTATION*

We support the need for comprehensive reform of the business tax system to promote Australia's competitiveness. At a time when the globalisation of trade in both goods and services, of information flows and of investment is of increasing significance, a more competitive tax system - of which business taxation is a key component - is a critical step forward. A better business tax system is fundamental to the ability of industry to take the leading position necessary if it is to deliver higher standards of living and sustainable new job opportunities to the benefit of all Australians.

Australia needs to put in place a remodeled business tax system geared to making us more internationally competitive not just against today's standards but, critically, in view of the accelerating dynamism of the international economy.

General Issues

Tax Reform Processes

We support the general approach to ongoing policy design, drafting of legislation and administration of taxation as outlined in the earlier Review of Business Taxation (RBT) discussion paper *A Strong Foundation*. In particular we support the adoption of a genuinely consultative approach to these areas and improvements to the accountability of the taxation authorities assisted by establishing an independent Board whether that be an advisory Board or a Board of Directors.

In view of the importance of the current business tax reform process we submit that the consultative approach currently in evidence as a result of the Review should be maintained in the context of the further design of policy proposals, the drafting of legislation and implementation of reform measures.

The Proposed Timetable for Implementation

We would also like to record our concern that the current timetable for business tax reform measures will not allow for a full involvement of the business community in providing input into policy and legislation. In view of the likely comprehensiveness of business tax measures and the extraordinary other demands on business (including the implementation of the GST and the "millenium bug") we favour a phased introduction of measures. The details of the phasing and the most effective sequencing of reforms should be settled after appropriate input from the business community.

Tax Incentives

There is widespread support for maintaining a flexible approach to the provision of tax incentives. There is a strong recognition of the wide variety of reasons for government intervention and a firm view that the option to provide assistance through the tax system should be maintained. There is very strong support for example for tax-based assistance for infrastructure projects and for research and development. Indeed, the 125% R&D concession should in our view be retained as a tax incentive, and possibly increased to maintain its real value in the face of a reduction in the entity rate tax.

Review and monitoring of the effectiveness of tax incentives more generally should be undertaken in consultation with the business community.

Anti-Avoidance

We agree the structural changes proposed in *A Platform for Consultation* (*Platform*) will enable the removal of many specific anti-avoidance rules. General anti-avoidance rules should be retained but the purpose threshold be no more severe than "sole or dominant". The introduction of a "principal effect" test (as has been proposed in the GST legislation) would introduce great uncertainty and would create a taxpayer perception of potential arbitrary application by the revenue authorities.

Specific Policy Areas

The following sections summarise the results of our discussions on specific business tax measures. More detailed consideration of each of these areas is enclosed in the attachment to this submission. Two important qualifications should made.

- Not all the positions proposed enjoy the unqualified support of all members of our organisations. Accordingly, the positions set out below do not preclude individual firms from putting their individual perspectives directly to the RBT.

- The very tight timeframe within which we are working necessarily implies that many of the detailed implications of measures have not been fully worked through. In the past week, for instance, new insights into the implications of various reforms to the imputation system and their interaction with international tax measures and options for consolidation have surfaced. We expect this experience to continue in the coming months. The positions indicated below therefore should be considered with this in mind.

Reforms to Imputation

While we are not convinced of the need for any of the options, the resident dividend withholding tax (RDWT) option would be strongly favoured over the deferred company tax on the grounds of the adverse impact of the latter on international competitiveness and on reported profits. We caution however that the RDWT adopted without adjustment could have a significant impact on reported earnings of particular firms.

Consistent Treatment of Entities

While we believe there is a more compelling case for taxing companies as trusts, we accept for revenue reasons a move towards a greater consistency of entity taxation along the general lines of taxing trusts as companies. We support the need for special treatment in a number of cases including collective investment vehicles (broadly defined), superannuation and life insurance. We also acknowledge the concerns of small, closely held entities and favour the exploration of measures to allow flow through of tax preferences on a selective basis.

Distributions

We would be prepared to accept a profits first rule where the substance of the distribution is a distribution of profits. Were the definition of a dividend to be expanded, an approach of specific inclusion would be most favoured. We believe an expanded definition of distributions for public companies is not warranted, would involve very high compliance costs for little gain and is therefore not supported.

Taxation of Entity Groups

There is support for a comprehensive consolidation regime on the condition that a number of critical improvements be built into the suggestions made in *Platform.*

International

Reforms to international taxation are seen as a means of improving international competitiveness. Several critical reform areas are very strongly supported. There should be a concerted effort to re-negotiate our double tax treaties. We should expand the creditability in Australia for foreign tax paid on foreign source income and combine this with a relaxation of restrictions on streaming of offshore earnings to foreign investors. There is a good measure of support for a careful tightening of thin capitalisation provisions applying both to outbound and inbound investment.

Wasting Assets, Goodwill and Trading Stock

While there is concern for the long-term investment implications of such a position, there appears to be considerable support for the removal of accelerated depreciation to fund a sustained reduction in the entity tax rate. We submit that policy flexibility should be maintained by keeping open the possibility for Government to grant accelerated write-off in particular circumstances. There is support for aligning the tax treatment of acquired goodwill with the accounting treatment. There is general support for a more consistent treatment of trading stock although the need for measures to alleviate the potentially severe impact on particular industries is recognised.

Taxation of Financial Arrangements, Leases and Rights

There is strong support for the proposal to adopt an accruals approach and an elective mark-to-market approach for the taxation of financial arrangements while retaining a realisations basis for taxing other assets and liabilities. There is support for retaining the existing treatment of leases although measures to prevent the assignment of lease tails would attract support. Greater allowance for expenditure on rights would also attract support.

Capital Gains Taxation

There is very strong support for allowing scrip for scrip rollover relief both for listed and non-listed companies. Provision to allow carry back of capital losses is also supported. There is some support for a limited provision for targetted relief from capital gains tax to encourage particular activities. There is substantial support for removing indexation and averaging of capital gains in favour of adopting a rate scale tapering down so that lower rates apply to assets held for longer periods.

Fringe Benefits Tax

There is no general support for the transfer of fringe benefits tax to the employee. There is very strong support for removing both on-premises car parking and entertainment expenses from the FBT regime (while removing the deductibility for entertainment expenses). There is support for the reduction of the favourable valuation of car benefits in the fringe benefits regime.

<u>ATTACHMENT</u>

to the

BCA/CTA SUBMISSION

on

A PLATFORM FOR CONSULTATION

This attachment supports the joint submission of the Business Council of Australia (BCA) and the Corporate Tax Association (CTA) to the Review of Business Taxation by addressing in greater detail the issues behind the positions presented in the submission.

In all cases it should be recognised that two important qualifications apply to the conclusions reached:

- Not all members of both our organisations agree unanimously with all the conclusions reached in this document and remain free to express their individual positions as they see fit.

- Discussions of the wide-ranging options for reform contained in *A Platform for Consultation* have only been in progress for less than eight weeks and there is still a considerable way to go in thinking through the implications of all the options.

Consequently, positions reached in this document should be interpreted as the current state of thinking in what is a rapidly evolving process.

Contents

Section 1

General Issues

1.1 This section investigates some general issues not covered elsewhere in this attachment.

Tax Processes

1.2 The BCA and the CTA place particular emphasis on reforms to the processes of tax design, drafting of legislation and administration. We applaud the sentiments and broad direction of reform in these areas as indicated in *A Strong Foundation* (*Foundation*) and refer to the submissions on *Foundation* made by the Business Coalition of Tax Reform for a business perspective on these matters.

1.3 Two features in particular are worth re-emphasising:

- the introduction of substantial avenues for genuine and ongoing consultation with the business community as an integral part of reformed processes of design, drafting and legislation

- the establishment of an independent Board of Directors or advisory Board to focus on processes and outcomes in relation to the business tax system.

1.4 We consider that processes by which the proposed changes to the business tax system are to be implemented should be fully in line with the consultative and transparent processes of policy development advocated in *Foundation.* Furthermore, ideally they should be implemented under the guidance of a Board of Directors or advisory Board.

The Proposed Timetable for Implementation

1.5 There is a concern that the current timetable for business tax reform measures will not allow for the full involvement of the business community in providing input into policy and legislation.

1.6 In view of the likely comprehensive nature of business tax reform measures and the extraordinary other demands on business (including the implementation of the GST and the "millenium bug") we favour a phased introduction of measures. The details of the phasing and the most effective sequencing of reforms should be settled after appropriate input from the business community.

1.7 *Platform* canvasses this possibility of a phased introduction of any reduction in the entity tax rate. Business recognises the importance of this perspective but itself places greater emphasis on the importance of:

- ensuring adequate time for considered input into the design of measures and the legislation giving them effect

- allowing business sufficient time to prepare for a change in tax practices.

The Tax Incentive Benchmark

1.8 *Platform* invites input from business to refine the tax incentive benchmark. In *Foundation* the tax incentive principle is:

> "Business tax incentives should be provided only following a formal assessment of their net impact on the national taxation objectives, and only where assessed to be an essential or superior form of government intervention."

1.9 There is an inherent difficulty in specifying the criteria for tax incentives arising from the variety of possible reasons for government support or assistance. These include equity considerations, policies to promote regional development, measures to match incentives available in competing countries as well as a narrower range of purely economic reasons relating to market failure and competitive neutrality as is found in the areas of infrastructure provision.

1.10 Given the potentially wide range of justifications for government intervention, it is possibly more important to distinguish the situations where intervention is most appropriately delivered in the form of a tax incentive in contrast to other means - such as direct expenditure.

1.11 Considerations that could be brought to bear on the assessment of the relative merits of incentives delivered directly or through the tax system include:

- Effective delivery of assistance based on measurable effects

- Effective targeting of assistance to those for whom the benefit is intended

- Direct compliance and administrative costs of the particular scheme

- Collateral compliance and administrative costs arising, for example, from the need for anti-avoidance measures to contain the use of the measure

- Security of the measure.

1.12 The BCA and the CTA submit that any review or monitoring arrangements should include genuine input from the business community to ensure deliberations benefit from those with first hand knowledge of the relevant commercial realities.

The R & D Tax Incentive

1.13 The 125% R&D tax incentive should in our view be retained as a tax incentive and possibly increased to maintain its real value in the face of the proposed rate reduction.

1.14 There is empirical evidence suggesting a close correlation between the tax incentive and the level of R&D spending by business, with a steady increase since the mid-1980's followed by a sharp drop shortly after the rate of the incentive was halved in 1996. Various studies by the Bureau of Industry Economics, the Industries Commission and the Mortimer Report suggest that external benefits are generated by the tax concession.

1.15 A combination of integrity measures introduced over time, including the narrowing of the definition of R&D, a much more limited registration period and constraints on the deductibility of feedstock costs now ensure the incentive is both highly targeted and likely to influence behaviour.

Revenue Neutrality

1.16 The condition of revenue neutrality (against the benchmark of the measures announced in *A New Tax System*) is a feature of the Review of Business Taxation's terms of reference. This condition set on business tax reform necessarily constrains the degree to which the Review can recommend measures to improve the overall international competitiveness of the business tax system.

1.17 *Platform* suggests the overall constraint of revenue neutrality might be subdivided into two separate revenue neutral exercises – one relating to changes to capital gains tax and the other relating to changes to general business tax measures. We submit that an approach that preserved the maximum degree of flexibility would appear more attractive than an approach that locked in unnecessary constraints.

Revenue Assumptions

1.18 We do not have a full knowledge of the revenue implications of the full range of measures raised in *Platform*. This is particularly important given the overall context of a revenue neutral trade-off of various features of the present tax system for a decrease in the entity tax rate.

1.19 Chapter 39 of *Platform* provides estimates of some of the more important options. There is, however, an important qualification in that some costings are said to be indicative only and may be modified in the light of further information.

1.20 While, as a part of the consultation process, the RBT has been helpful in explaining the basis of the indicative revenue estimates, there are concerns about some of the costings. This is particularly so in view of the historical experience with highly conservative estimates of revenue under, for example, the capital gains tax and the fringe benefits tax. A number of estimates contained in Platform appear to understate the potential revenue gain.

1.21 There has been particular concern over the costing of the removal of accelerated depreciation given the relative importance of this number in consideration of the rate/base trade-off. In making judgements about the impact of the possible lower entity tax rate financed largely from the removal of accelerated depreciation, individual businesses have generally accepted the comment in *Platform* that the 2003-04 estimates of measures are "broadly indicative of the longer run revenue trade-off". In other words there has been a general assumption that the removal of accelerated depreciation on plant and equipment would finance a reduction in the company tax rate of around 4.5 percentage points on an ongoing basis. To the extent there is support for the trade-off of accelerated depreciation for a lower entity tax rate, this support should be interpreted as being predicated on the sustainability of this relationship.

Growth Dividend and Compliance Cost Dividend

1.22 The revenue estimate for the growth dividend appears highly conservative in the light of the strength of the case put for business tax reform in *Foundation.* The BCA and the CTA are willing to liaise with the Review with a view to commissioning further research into the likely revenue gain from reform measures. This research could build upon work into the effects of tax reform on economic performance already commissioned by the business community.

1.23 A major reason for business tax reform is the reduction in complexity and compliance costs. Such a reduction in compliance costs represents a potentially valuable source of revenue as the level of deductible compliance activities would be reduced. There is no allowance in *Platform* for the favourable revenue effects of compliance costs savings.

Further Development of Positions and Priorities

1.24 The CTA and the BCA have collaborated in putting together this document in the spirit of the consultative interaction between the RBT and the business community. In doing so we expect to continue to contribute constructively to the formation of policy positions through the RBT. Thus the conclusions reached in the sections that follow do not in any sense constitute a recommended reform package. In particular they do not represent the last word for our organisations on the important issue of the base/rate trade off.

1.25 We clearly recognise that if all the conclusions put forward in the following sections were adopted we would not be able, at least in the short term, to meet both the 30% entity tax rate many aspire to and the revenue neutrality constraint.

1.26 We, like other sections of the business community, still have many issues to consider before we can finalise our preferred mix of measures. In view of the momentum in favour of the 30 percent rate, we have a range of options we need to prioritise and assess against a range of criteria including their short-term impact on the entity tax rate.

Section 2

Reforms to Imputation

Overview

2.1 The stated rationale behind the proposed changes to imputation is that the existing system is too complex, there is the potential to stream franking credits so as to maximise their value, excess imputation credits are not refunded to low marginal rate shareholders who are therefore at a disadvantage, and the section 46 inter-company dividend rebate creates unintended loopholes.

2.2 To overcome these problems, a deferred company tax (DCT) has been proposed whereby company level dividends paid out of untaxed profits would be taxed at the company tax rate, so they would be fully franked. DCT would be an extra charge against the paying company's profits.

2.3 In the face of business concerns with DCT, two further alternatives have been put forward to reform the imputation system. As an alternative, a resident dividend withholding tax (RDWT) applicable to unfranked dividends is proposed whereby tax at the corporate rate would be withheld from all unfranked dividends to cover the liability of the shareholder to tax.

2.4 Under a third alternative, all unfranked dividends passing between corporate entities would be taxable. The latter proposal may not meet the Government's integrity requirement in that unfranked dividends paid by companies to individuals are left to be taxed in the individual's hands without ensuring that the tax has been paid upfront.

2.5 A cash refund of excess imputation credits has also been proposed for individuals and superannuation funds.

2.6 Business is strongly opposed to the DCT but is not convinced that either of the other two options would achieve much more than bringing forward the timing of tax collections on a once-off basis. This does not represent a substantial improvement to the tax base. Subject to these concerns, we do have some comments to make on the matters raised in *Platform*.

Summary of Conclusions

2.7 Given that business is strongly opposed to the DCT:

(a) The preferred option is a RDWT, coupled together with the NRITC regime proposed for refunding RDWT paid through the entity chain to non-residents. RDWT should also be refunded to Australian tax exempt entities.

(b) A strong case can be made for not subjecting unfranked dividends received by public companies to RDWT.

(c) Dividend streaming, i.e. the ability to stream foreign source income to foreign shareholders and domestic income to domestic shareholders, should be considered separately from any of the options to reform imputation.

(d) Inter-company dividends should not absorb tax losses of the recipient entity by allowing a dividends received deduction or exemption as outlined for public companies.

(e) An elective advance payment of tax on temporary tax preferences as a mechanism to avoid double taxation should be introduced.

(f) Transitional issues should be introduced that allow dividends declared before the start date of the new regime to be grandfathered. The start date of the new imputation changes should be aligned with the consolidation rules start date to avoid mismatches, i.e. dividends between wholly owned entities being subject to RDWT.

Critical Issues

Business opposition to DCT

2.8 The proposed DCT system is strongly opposed by business. Particular concerns have been raised as follows:

(a) DCT is a charge against company profits which would reduce earnings per share and could be expected to adversely impact the valuation of companies thus increasing the cost of raising capital.

(b) a flow on effect of (a) above is that Australian companies may be more susceptible to takeover due to lower valuations.

(c) new investment in Australia may fall as investment capital is directed to other jurisdictions offering greater returns.

(d) DCT could be perceived to be contrary to the spirit of Australia’s double tax treaties which generally impose 15% withholding tax on unfranked dividends. This in turn may make negotiation and renegotiation of treaties which is much needed to become internationally competitive, more difficult.

(e) DCT is unlikely to give rise to a credit for foreign taxes to foreign investors, again diminishing Australia's ability to attract foreign capital.

Support for resident dividend withholding tax (RDWT)

2.9 The RDWT is the preferred option for reform as:

(a) RDWT does not entail the harsh impact on corporate profits to a payor of dividends and flow on effects that a DCT does. Dividend yields could therefore be maintained and company valuations not affected.

(b) At the same time however, RDWT would ensure that all distributions to individuals would be taxed at source, thus satisfying integrity concerns, ie. that tax is collected on such dividends.

(c) Refund of excess imputation credits could still be provided for.

(d) Finally there would not be a need to renegotiate treaties in respect of DCT.

2.10 Dividend streaming rules dealing with situations such as where franked dividends were paid to some shareholders and unfranked dividends to others would need to be retained under this option. We suggest, as outlined in our comments on anti-avoidance provisions, that such streaming rules need to be rationalised and simplified.

Exclusions from RDWT

2.11 Our recommended exclusions are as follows:

(a) Dividends paid to non-resident shareholders from the existing Foreign Dividend Account (or the proposed Foreign Income Account).

(b) RDWT should be refunded to non-residents and replaced with a DWT as part of the non-resident tax credit proposal. In addition, RDWT should be refunded entirely to tax exempt residents e.g. charities.

(c) In addition a case is emerging for excluding dividends derived by public companies for the following reasons:

- If RDWT was imposed on such dividends, this would mean that tax preferences were taxed prior to the related income being distributed outside the company chain to individuals and superannuation funds, etc. We believe there are sufficient forces acting on public companies to encourage distribution within a short time-frame.

- Taxing unfranked dividends to public companies discourages incorporated joint ventures which have tax preferences. Joint ventures where separate parties pool different resources are a major source of economic growth. It is understood that projects such as the “Very Fast Train” project did not proceed primarily because tax preferences such as tax losses could not be obtained through a vehicle having limited liability, e.g. a company. Imposing RDWT on unfranked dividends is a further impediment to joint ventures.

- Internationally, Australia’s tax system would become more uncompetitive in the area of joint ventures. Currently, losses can not flow through from incorporated joint ventures. The RDWT measure would also tax preferences distributed by a joint venture vehicle. By way of comparison, the US tax system allows tax preferences to flow through to investors while having limited liability through the use of flow through vehicles such as limited liability companies and limited partnerships. Dividends received by US corporations are taxed, but with a dividends received deduction based on the percentage holding.

- For new joint ventures, public companies will tend to favour unincorporated joint ventures or general partnerships which allow preferences to flow through to the corporate investor level. In this way the principle of neutrality as between different organisational forms will be offended.

- Taxing unfranked dividends received by public companies could represent a major negative impact on the international competitiveness of some specific business sectors such as listed investment companies, insurance company subsidiaries having investment portfolios and other companies in joint ventures, i.e. non-wholly owned investment situations. It is not clear whether a sufficient case has been made out by the RBT to adversely impact these cases over others who are structured differently.

Taxation of unfranked inter-entity distributions

2.12 Whilst this option essentially achieves the same as the first two options for inter-entity distributions, unfranked dividends paid to individual shareholders would not be taxed at source. Rather they would be taxed in the recipient’s hands. This option is less strongly supported as it may not meet the integrity concern i.e. the potential that unfranked dividends will not be declared as income. Again, complex dividend streaming rules would potentially remain with this option. There would however, be some reduction in compliance as there would be no need to pay DCT or deduct RDWT from unfranked dividends.

Non resident investor tax credit

2.13 Under both the DCT and RDWT proposals, non-resident investors into Australia could be disadvantaged due to the extra tax on distributions through the entity chain. In the case of DCT, it is proposed that DCT on distributions to non-residents be refunded and replaced with a withholding tax to increase the creditability of Australian tax in the home jurisdiction. Where distributions paid between resident entities are subject to RDWT and subsequently paid to foreign investors, RDWT could be refunded and DWT applied to the dividend plus the refund, thus putting the non-resident investor into the same tax position as under the current regime.

2.14 We support the measure of refunding RDWT on the grounds that this would again be in line with the objective of promoting Australia's international competitiveness.

Streaming of dividends

2.15 This issue is dealt with in our comments in Section 6 "International Tax Issues."

2.16 In addition to those comments, we note that the streaming of dividends out of foreign income to non-residents should not be linked to any of the changes to the dividend imputation system. Rather, streaming as an option could exist in tandem with the RDWT.

Inter-company dividends and tax losses

2.17 Reference is made to the comments in Section 5 of this submission "Taxation of Entity Groups", and the need to ensure that dividends received through a corporate chain do not waste legitimate tax losses.

2.18 In addition to those comments, it is noted that under the RDWT all dividends received by a company in tax loss will have borne full company tax either through the payment of tax on the profits out of which the dividend is paid or through the withholding of tax under the RDWT mechanism. In this way there is full franking of dividends within the corporate chain, thus achieving a major initiative in the reform of the imputation system.

2.19 However there should not be a second level of tax through the absorption of any tax losses. Table 17.2 at page 397 of *Platform* shows that even though in cash terms there is tax paid equal to the ultimate investor's tax rate i.e. 30%, there is a second level of effective tax through the utilisation of losses at the receiving company level. This can be avoided through the allowance of a full dividends received deduction or exemption. Such a measure may need to be accompanied by rules which allow losses to be unaffected by dividends received as is currently provided in relation to dividends which are exempt from tax under Section 23AJ.

2.20 While historically dividends have technically offset tax losses, we believe that the fundamental changes to imputation proposed and consolidations warrant a different approach being taken as outlined above.

2.21 Finally, we support the proposal whereby dividends paid between entities within a consolidated group would not attract DCT or RDWT.

Other Issues

Addressing the potential for double taxation of distributed tax preferences

2.22 The potential for double taxation arising through distribution of tax preferences is also addressed in *Platform*. Four options for overcoming such double taxation are detailed. Our comments thereon are detailed below. Option 3 is preferred.

<u>Option 1</u>: Refunding franking account surpluses on liquidation to the extent that the surplus relates to temporary tax differences.

This option does not address the issue of double taxation at the time it occurs. Rather, it adopts the commercially unrealistic position of recovering surpluses on liquidation. Businesses do not operate in the contemplation of liquidation. In addition, there are problems of identification of when the surplus relates to temporary as opposed to permanent tax preferences on liquidation, which makes this option not viable.

<u>Option 2:</u> Allow “double tax” payments to be offset against company tax liabilities.

This option is acknowledged to operate only within the confines of a DCT, which is not supported in this submission.

<u>Option 3</u>: Allow prepayments of tax on temporary tax preferences.

This option is supported so that a company could prepay tax on temporary tax preferences (not permanent tax preferences) to overcome double tax situations. This option should operate at the election of the dividend payer so that the payer could either pay corporate tax thus creating franking credits or alternatively pay an unfranked dividend subject to RDWT.

Option 4: Adjust the cost base of the funding asset for distributions from unrealised gains.

This is considered not to be an effective solution to double tax as dividends are rarely paid out of unrealised profits.

Transitional issues

2.23 There are a number of issues to address including:

(a) Ensuring that the arrangements do not impact on dividends that have been validly declared prior to the start date but that are paid thereafter;

(b) Aligning the revised imputation rules with the start date for a consolidation regime such that DCT or RDWT cannot apply to dividends between wholly owned entities that elect into the consolidation regime from the commencement of that regime.

Section 3

Consistent Taxation Of Entities

Overview

3.1 *Platform* proposes a level playing field concept whereby most entities including companies, co-operatives, unincorporated associations, most trusts and limited partnerships would be taxed as companies. The stated rationale for such a proposal is that investments should not be taxed differently whether they are housed within a trust as opposed to a company and that business tax arrangements should avoid taxing different types of entities differently. Certain trusts would be excluded from the new entity regime, including deceased estates, bare trusts and court-order trusts, certain stakeholders and collective investments vehicles (CIVs).

3.2 CIVs are essentially widely held vehicles which undertake passive investments, do not control business operations and flow through profits annually. Income earned by such vehicles will not be taxed in the hands of the trustee but rather in the hands of individual investors at their marginal tax rates with the character of the income flowing through to investors e.g., capital gains. This will ensure that there are no adverse cash flow effects on investors receiving distributions of assessable income from vehicles such as cash management trusts. This rule could also apply to other widely held vehicles which distribute their income annually such as bond trusts, common funds, managed funds and property trusts.

3.3 Issues remain open for a CIV as to whether tax preferences will continue to flow through to investors in a tax free manner or as a reduction in the investor's cost base in the vehicle, or simply be taxed.

Summary of Conclusions

3.4 There is support for the following reform measures:

(a) The taxation of most entities as companies with the exceptions noted below under the heading “Entities to be excluded from the entity tax regime”;

(b) The flow through of the character of income and tax preferences of CIV’s to investors in accordance with current tax law with permissible activities limited to those covered in the public trading trust provisions of the tax law;

(c) The selective flow through of tax preferences for other entities (essentially closely held businesses below a certain size);

(d) Broad transitional arrangements for trusts that are brought within the entity taxation regime.

Critical Issues

Entities to be excluded from the entity tax regime

3.5 We support the concept of taxation of most entities as companies with the exception of:

(a) CIV's as defined in *Platform* with their activities to include those covered in the definition of "eligible investment business" in Section 102M of the Income Tax Assessment Act 1936;

(b) Superannuation Funds, Approved Deposit Funds, Pooled Superannuation Trusts due to the continuing need to support retirement savings. In this regard we would endorse the submission of the Association of Superannuation Funds of Australia to the RBT;

(c) Trusts wholly owned by CIV's and/or funds mentioned in (b) above provided those trusts comply with the CIV rules regarding type of activity and annual distribution requirements;

(d) Life companies for which special rules need to be worked out in consultation with the life industry;

(e) Other trusts such as deceased estates, bare trusts, court ordered trusts as outlined in *Platform;*

(f) In addition, we support the exclusion of employee share scheme trusts from the entity regime based on the need to encourage ownership of companies by employees to promote productivity and efficiency.

Flow through of tax preferences

3.6 *Platform* proposes that no tax preferences would flow through to investors/shareholders with a possible exception for CIVs, provided the permissible range of activities for CIVs was limited to passive activities. If they were extended to other business activities on a wide basis the flow through of tax preferences could be costly to the revenue.

3.7 In our view, the permissible range of activities for CIVs should be based on the current rules for public trading trusts rather than introducing a distinction relying on an uncertain distinction between passive and active activity.

3.8 Full flow of tax preferences for CIV's in accordance with current tax rules for these activities should be allowed for the following reasons:

(a) These rules allow a broad cross-section of investors access to a diversification of investment portfolios which would otherwise would not be available.

(b) In this way the benefits of tax preferences are available to all people and not just those who as individuals have the means to invest directly in shares, bonds and property rather than through public trading trusts. To not allow the flow through of existing tax preferences would favour more wealthy sectors of the community over others.

(c) Basing flow through of tax preferences on a passive/active distinction creates difficulties in defining the dividing line in any meaningful way whereas the current rules are well understood and widely accepted.

Other Issues

Selective flow-through of tax preferences to other entities

3.9 There is also a case for some selective flow-through of tax preferences to other entities i.e., non-CIV's – particularly where there is a high degree of substitutability between conducting business as a sole trader or partnership and conducting business through an entity. This would essentially be an exception for closely held businesses not exceeding a certain size.

Transitional arrangements for trusts

3.10 Rules are proposed for preserving the existing tax treatment of certain amounts earned by trusts prior to the commencement of the new entity tax system and of future capital gains on existing assets. This would be achieved by converting these amounts into contributed capital. Such amounts include for assets at the start date, realised gains on pre-CGT assets, realised inflationary gains on post-CGT assets, realised gains benefiting from the CGT goodwill exemption, other tax preferred income earned prior to commencement and prior taxed income.

3.11 We support broad transitional rules to alleviate the potentially harsh impact changes could have on existing arrangements.

Section 4

Taxation of Dividends and the Profits First Rule

Overview

4.1 The definition of a dividend is proposed to be broadened under one of three options as follows:

Option 1: Broad definition covering all benefits provided by an entity to members.

Option 2: Broad definition but exclude certain benefits provided by widely held entities.

Option 3: Adopt Option 1 or 2 but tax certain benefits under FBT.

4.2 The intent is clearly to broaden the tax base to tax such items as goods and services provided to shareholders at a discount, debt forgivenesses and non-commercial loans. An extended definition would apply in certain cases even where benefits were provided to associates. Dividends would continue to be limited to profits.

4.3 A further measure would limit the scope of taxable entities to choose whether distributions are made from capital and/or profits. Rather, a profits first rule would be applied whereby distributions would be deemed to have been made from taxed profits first, untaxed profits second and then contributed capital. In certain cases a slice approach would be adopted where the shareholder would be deemed to be receive a slice of capital, taxed and untaxed profit.

Summary of Conclusions

4.4 There is support for the following reforms:

(a) For public companies we support maintaining the current definition of a dividend.

(b) Where the definition of a dividend is expanded we support amendment by way of specific inclusion rather than a general all encompassing definition.

(c) We only support a profits first rule where the substance is a distribution of profits - i.e. a normal company dividend. In circumstances where there is a proportional share buyback a slice approach seems to be the most reflective of the substance of the transaction. Where there is a complete termination of a shareholder's interest in a company then sale treatment should apply at the shareholder and company level. Reference should be made to the US tax law regarding the profits first rule and exceptions thereto as these provide a well thought through set of rules developed over many years.

(d) In relation to the determination of profits, these should be determined having regard to the book value of a company's assets as stated in the balance sheet rather than taking market values. In relation to determining the share capital account of a company, we support the use of existing rules, i.e. using the company's share capital account in the balance sheet and not a separate account for taxation purposes.

Critical Issues

Definition of a dividend

4.5 We do not support the application of the broad definition (Option 1) to widely held entities which are treated as public companies for tax purposes. Rather, we believe the current definition should be maintained for public companies because of the separation of shareholders from the entity, and the corporate governance rules under which most public companies operate which prevent disguised dividends being made to shareholders.

4.6 We note that a number of the other measures in *Platform* and the existing law will mean that an extended definition should not be required:

(a) With the proposal for a consolidation regime, companies will generally be forced to elect into that regime in order to be able to offset profits and losses amongst entities. This will render any transactions that would otherwise be dividends amongst entities within the consolidated group non-taxable i.e. there will be no dividend and therefore the extended definition can not have any application. Only a transaction going outside a consolidated group could be a dividend.

(b) In an international environment there are transfer pricing rules in place to impose market value prices on transactions entered into on a non arm's-length basis. Such rules discourage the passing of value in the form of disguised dividends to related non-resident shareholders.

4.7 Only transactions with domestic shareholders outside a consolidated group would appear to be relevant, and as explained above for governance reasons disguised dividends are not an issue with public companies in this regard.

4.8 We acknowledge that discounted goods or services are provided by some public companies to shareholders. However we believe that these should not be taxed as a dividend. As noted at paragraph 18.25 of *Platform*, for compliance reasons a $1,000 threshold could be included in the definition of a dividend with only the excess being taxed. Based on a 10% discount being provided (which is higher than most shareholder loyalty schemes), this would amount to $10,000 gross of goods and services provided to a shareholder before a dividend arose. It is suggested that there would be very few cases where a dividend would arise because of the threshold, such that the costs of administration would be highly disproportionate to any revenue gains from this measure.

4.9 If an expanded definition is to apply to public companies, then Option 2 is to be preferred as it is the Option which most closely reflects the reality of what public companies provide to shareholders and associates.

4.10 In regard to the definition of a dividend it is suggested that if it is to be amended, that specific items be included to create clarity rather than have a general definition which creates uncertainty. The penalties for an all encompassing general definition include the likelihood of significant litigation to define boundaries and potentially harsh outcomes for shareholders when they are deemed to have received dividends and for companies who would lose franking credits when a dividend is deemed.

Profits first rule

4.11 We generally support a profits first rule for dividends paid in the ordinary course of events by companies as this tends to accord with the economic substance.

4.12 In addition, we support the slice approach where there is a proportional share buyback such that the economic interest of each shareholder as a percentage of total ownership remains approximately the same. Difficulties are acknowledged with the arbitrary nature of the slice approach rules where profits and capital are allocated to a distribution irrespective of how much capital the relevant shareholder has contributed. However in a public company situation, given the large number of shareholders who are turning over shares regularly we do not believe that would necessarily create issues which were unacceptable.

4.13 However we do not support the profits first rule or slice approach where there is a transaction where the economic interest of the shareholder is being completely terminated e.g. a selective share buyback, complete liquidation of a company, or there is a substantial reduction in a shareholder's shareholding. The public discussion paper dealing with share capital rules issued by Treasury and the Australian Taxation Office on 1 July 1996 provided a definition of a "substantial reduction" for these purposes. The substance of such transactions is that there is a sale of equity by the relevant shareholder.

4.14 In these cases, a capital treatment should be applied equally at the shareholder and company level - i.e. the shareholder would receive capital gains treatment and the company would show a return of capital and franking credits could not be used.

4.15 In addition, the 1996 paper acknowledged there would be genuine return of capital, i.e. the profits first rule would not apply to the extent that a distribution represented the proceeds on the sale of a part of the company's business, provided it was not part of a dividend substitution arrangement. We support this approach, but note that the entire distribution should be treated as a capital return in this case rather than simply the amount of share capital as measured by the share capital account.

4.16 The US tax regime (broadly sections 302 and 331 to 337 of the Internal Revenue Code) has a well developed set of rules which could be followed in respect of a profits first rule and the exceptions thereto where capital treatment would apply.

Determination of distributable profits under a profits first rule

4.17 We foresee significant problems with the proposal that distributable profits could be defined as the market value of the entity's net assets less contributed capital at the time of distribution. This would create many difficulties, including the need to value assets at the time of each distribution, as well as dealing with the problem of distributions being deemed to be dividends based on the market value of assets at one point in time where soon thereafter the market value substantially declined. Use of market values in these circumstances is clearly inappropriate.

Determining contributed capital

4.18 Where it is necessary to determine a company's contributed capital for the purposes of determining a shareholder's tax liability, we support Option 1 "Use Existing Rules" which drive off a company share capital account in the balance sheet to determine what is contributed capital. The use of the alternate approach in Option 2 "Employ a Separate

Contributed Capital Account for Tax Purposes" creates a significant compliance burden of maintaining a separate account from that recorded in a company's balance sheet.

Overview

5.1 The consolidation proposals canvassed in *Platform* seek to overcome a number of integrity concerns about the existing system by taxing corporate groups as single entities. If implemented, these proposals would also deliver a number of benefits to corporate groups - the transfer of franking credits, the freeing up of loss transfers, simpler intra-group dividend flows, and fewer tax barriers to reorganisation. It is noted, however, that all of these improvements could be achieved outside the complex framework of the consolidation proposals.

5.2 In their present form, the proposals include a number of design features that would reduce the competitiveness of many corporate groups. There are particular concerns about the proposal to repeal the same business test, which permits the carry forward of losses in entities following a change in majority ownership.

5.3 Our approach to the proposals for the taxation of entity groups has been to identify issues that create difficulties for business and to suggest ways of resolving those difficulties. A number of the issues identified would, without modification of some aspects of the proposals, operate in quite a detrimental way for many corporate groups, and unless those matters can be resolved, business would strongly prefer to maintain the status quo.

5.4 Consultation between business and the RBT about these issues has been very constructive. There is every reason to expect that further consultation can produce an outcome that will achieve the broad integrity objectives of the *Platform* proposals without imposing unnecessary costs on business.

5.5 No significant reductions in compliance work or in the overall level of complexity are expected to result from these measures. Indeed, the consolidation measures on their own are not expected to fully address all the integrity concerns, and *Platform* acknowledges that additional measures to prevent loss duplication and value shifting outside the consolidated group will still be required.

Summary of Conclusions

5.6 The following conclusions emerge:

(a) Further consultation is needed about ways of addressing the integrity concerns associated with the use of a non-resident holding company.

(b) If those and other concerns cannot be satisfactorily addressed, consolidation should be optional, with specific grouping and rollover benefits being available outside the consolidation regime.

(c) We are strongly opposed to the suggestion that losses should be forfeited on entry into a consolidated group (Option 1).

(d) Of the other options canvassed, we would support Option 6 (leaving the acquired entity outside the group), subject to some minor modification. However, we suggest consideration be given to a further alternative, which would limit loss carry forwards to the amount paid for the shares and remove the same business test.

(e) We consider that normal fluctuations in the share register of a listed company should not be viewed as giving rise to a change in underlying ownership.

(f) One of the three options put forward in our comments on the tax treatment of intercompany dividends should be adopted to avoid the significant commercial damage to a number of groups that would otherwise occur on implementation of the consolidation proposals.

(g) Consideration should be given to reducing the threshold for consolidation to less than 100%.

(h) Joint and several liability should not continue beyond exit from the group.

(i) A pro rata system of interest allocation and quarantining of deductions must not be an outcome of treating the entire group as a single entity. The tracing of funds to ensure interest deductibility should no longer be required.

(j) The general preference of BCA/CTA members seems to be for the assets based model for dealing with group exit, although that view is not completely unanimous.

(k) Transitional trust losses should be quarantined on the implementation of the consolidation measures, and should be available for offset against future trust income.

(l) Existing carry-forward losses within wholly owned groups that cannot presently be transferred should be made available to the consolidated group.

(m) Value shifting measures outside wholly owned groups should have a 50% control threshold, with a taxing point at the time of subsequent disposal. Cost base adjustments should reflect the value shift, and safe harbour rules combined with a substantial de minimus exemption are needed to confine the operation of such measures to circumstances where real mischief is likely to occur.

Critical Issues

The need for a resident Australian holding company

5.7 Under the *Platform* proposals, the consolidation regime will only be available to Australian entities that are wholly owned by a common foreign parent where they sit under an Australian resident holding entity. While improved grouping arrangements will be available to qualifying groups, all existing benefits are to be withdrawn.

5.8 Many foreign investors will already be structured in a way that satisfies this requirement, while others may be able to restructure at little cost (subject to obtaining stamp duty relief). However, some groups may have multiple entry points into Australia for reasons that are completely unrelated to Australian tax. For instance, there may be good commercial reasons for conducting separate Australian businesses through independent operating groups. In other cases the structure may represent an optimal mechanism for streaming Australian dividends in a way that meets the investor's foreign tax objectives.

5.9 For these reasons, it may therefore be inappropriate to restructure existing groups to include an Australian resident holding company. In addition, substantial costs may be incurred in foreign jurisdictions where Australian assets have to be transferred to a resident Australian holding company in order to satisfy the consolidation requirements. A number of countries do not provide CGT rollover relief for restructuring those investments. Canada does not. Nor, for that matter, does Australia grant rollover relief of the kind some foreign investors would need in their home jurisdictions in order to qualify for Australia's proposed consolidation regime.

5.10 Removing the existing provisions for all groups, including those that are unable to achieve an Australian resident holding company structure, threatens to leave some groups in a much worse position than at present, and drive up their effective Australian tax rate. Given some of the problems with the consolidation proposals, and depending on how those problems are resolved, it is questionable whether the achievement of what is regarded by the RBT as desirable tax policy can be justified by pressuring taxpayers into accepting a particular regime.

5.11 While it is noted the US requires a resident holding company before its consolidation regime may apply, care needs to be taken in making such comparisons. The US is a much larger economy with a proportionately much larger domestic base when compared with Australia. As a significant capital-importing nation, it is therefore of greater importance for Australia to attract and retain foreign investment.

5.12 It is understood there are two principal drivers behind the proposal for a resident Australian parent:

Integrity concerns

5.13 The revenue authorities are not entirely confident about being able to verify the continued 100% ownership up the chain outside Australia, particularly through countries that do not have reciprocal exchange of information arrangements with Australia. Those concerns are difficult to reconcile with a self-assessment regime, plus the fact that offshore tracing has been permitted for more than a decade for the purposes of grouping losses. Even if the integrity concerns are well founded (and there appears to be no evidence of this), it is unlikely that an examination of the on-shore holding company would necessarily reveal a disguised split in the ownership structure further up the chain.

5.14 Business does not believe the integrity concerns are insurmountable, and they are certainly not strong enough to warrant the extreme sanction of denying grouping and CGT rollover relief for existing structures. Possible ways of addressing the concerns include obtaining a formal declaration from the Public Officer of the Australian group to the effect that 100% ownership has been maintained.

Calculating gains or losses on exit

5.15 The inclusion of an offshore holding company in the consolidated group could produce in a different gain or loss on the eventual disposal of subsidiaries. However, this problem could be substantially overcome by adopting one of the options canvassed in Chapter 28 for adjusting the cost base outside the consolidation regime. As noted in Table 28.5 on page 604, those options do not capture all tax preferencing, although it is understood that most timing differences will produce cost base adjustments in the case of unrealised gains and losses.

5.16 It is suggested that the integrity issues can be resolved, and the resulting level of complexity would not be insurmountable. Corporate groups that are unable to restructure at reasonable cost would much prefer to bear the additional compliance costs to the downside of being denied the existing benefits of loss grouping and CGT rollover relief. Further consultation will be needed to settle this issue.

5.17 An exception to the proposed “all in” rule would have to be made if a way cannot be found to overcome the integrity concerns behind the resident holding company rule. For groups that are unable to restructure in the required way, the full benefits of consolidation should be available outside the consolidation regime – including the grouping of franking credits. This should apply equally to future investment, particularly where there are mergers at a global level, and the foreign investors already have their separate entry points into Australia.

Forfeiture of tax losses on entry

5.18 Because of concerns about loss cascading and duplication, the indicated preference from the RBT is for a model that, subject to transitional rules, would cause pre-entry losses to be forfeited on entry into the consolidated group. If adopted, this proposal would represent a radical departure from the existing regime, which permits the carry forward of pre-entry losses subject to the same business test.

5.19 Loss forfeiture on entry would involve a negative impact on earnings where the loss entity has tax effected its pre-entry losses. If implemented, this proposal would therefore be replacing one anti-merger poison pill (CGT – assuming the scrip for scrip proposal proceeds) with another (the destruction of shareholder value through loss forfeiture on merger).

5.20 The same business test was introduced many years before capital gains tax, but *Platform* considers the two measures operating side by side can produce unplanned loss duplication. For example, an investor realises a CGT loss on the disposal of shares in a company used to operate the family business, the company having incurred trading losses over a period of years. That loss may be offset against taxable capital gains of the investor, providing tax relief at one level.

5.21 If the new owner of the shares can also offset future assessable income from business activities against the losses incurred by the previous owner and carried forward in the company, there would be a second level of tax relief in respect of the same economic loss. The argument is that the original investor has already benefited from the economic loss once (on the disposal of the shares), and the new owner should therefore not receive a further benefit through the company.

5.22 This analysis works after a fashion where the loss in question is a permanent loss resulting from, say, unprofitable trading activities. In other cases, however, the pre-entry loss may be the result of tax timing differences (e.g. accelerated depreciation or mining and petroleum exploration expenditure). Those timing differences can be expected to reverse over time, and it is unlikely in most cases that losses (or reduced gains) will arise as a result of disposing of the shares in the entity. The consideration of the loss duplication issue in *Platform* is confined entirely to the former kind of loss.

5.23 Strictly speaking, where loss duplication does occur it would only involve a deferral. The new owner would be taxed later on distribution or disposal, although the deferral could become almost permanent where the new owner can avoid distributing untaxed income out of the entity or disposing of the shares (this will not always be possible in practice). The question is whether the policy objective is to achieve long-term symmetry or just to improve short-term revenue outcomes by preventing deferrals.

5.24 Shares in companies are valued on the basis of expected future profits. The share price of some high technology start-up companies with little or no earnings track record may be based entirely on future earnings. Some internet stocks are good examples of that, as were some of the speculative mining stocks in the past. While those companies almost invariably have tax losses to carry forward, those losses would not be factored into their share price to any significant extent. To the extent that future earnings expectations are reflected in the current share price, shareholders are effectively taxed on those future earnings on the disposal of the shares. In such cases, the forfeiture of tax losses would result in double taxation.

5.25 Where the change in ownership is less than 100%, (for example, where minority shareholders are left with a continuing stake of 20% or 30% in the company after a takeover offer, which is not uncommon), a lack of symmetry arises on loss forfeiture at the entity level. This is because absent the same business test, the <u>entire</u> carry forward loss in the entity would be forfeited on passing the 50% continuity of ownership threshold, while only <u>part</u> of the economic loss (assuming there is one) is realised on the disposal of shares by the accepting shareholders.

5.26 Also, the term "loss duplication" is misleading since it implies a replication of the same loss, both in quantum and in character. Character is important because CGT losses may only be offset against CGT gains. The quarantining of CGT losses means that the economic impact of the loss incurred by the initial investor in disposing of the shares in the company will often be deferred for many years – sometimes indefinitely. While loss quarantining has always been a feature of the CGT system, the likely use of the losses is relevant since the analysis in *Platform* focuses on economic issues.

5.27 These factors, taken together, substantially counteract concerns about the new owner sometimes being able to defer the reversal of loss "duplication" on the distribution of untaxed profits or the eventual disposal of the shares. On balance, the case for loss forfeiture on entry and the repeal of the same business test has simply not been made out.

5.28 Of the other five options canvassed in Chapter 26, business would probably prefer options 5 or 6, both of which contemplate separate entity treatment of the loss company within the consolidated group. Option 5 (quarantining losses within the group) would need to be modified to accommodate sub-groups, which would lead to a high degree of complexity, with the loss company simultaneously being part of the consolidated group and its own sub-group.

5.29 Option 6, which leaves the acquired entity outside the consolidated group, would be less complex, while also achieving the objective of preserving the pre-entry losses. Under Option 6, post-acquisition losses of the acquired entity should be available to the consolidated group on entry, and there should be an option to abandon the pre-entry losses at any time to enter the consolidated group. This option would represent a departure from the "all in" consolidation principle, and would also leave all the existing problems associated with the same business test. Apart from the uncertainty created by such a test, companies are also prevented from taking sensible measures to improve profitability.

5.30 One further option to consider might be to limit the losses brought into the consolidated group to the consideration paid for the shares. For example, where the losses carried forward are $100, but the market value of the business is only $50, the losses on entry would be automatically limited to $50. Under this option, the same business test would no longer apply, and the reduced losses (where applicable) would be available to the consolidated group.

5.31 Adopting this option would reduce the impact on revenue where the net value of a loss company is not much more than the discounted value of its unrecouped tax losses, and would act as a more effective deterrent to loss trafficking than the current provisions. Following a change in ownership, companies could also focus on improving the business without being hamstrung by the artificial and uneconomic constraints of the same business test.

5.32 It is suggested that the removal of the same business test should be accompanied by the removal of the need for public companies to constantly track the daily fluctuations in their share registers in case there has been a cumulative change in continuing ownership. Loss trafficking simply does not occur in public companies in this fashion, and changes in ownership for loss carry forward purposes should be confined to major transactions. That is where the potential mischief lies.

Inter-company dividends

5.33 Unless changes are made to the tax treatment of dividends flowing between companies, the proposed consolidation rules will cause significant commercial damage to a number of company groups.

5.34 Under the current system, the multiple taxation of dividends flowing between companies is addressed through a rebate system. This means the dividend represents assessable income, and a credit is allowed against the tax payable in respect of the dividend. The rebate system is an effective mechanism for allowing the tax-free flow through of dividends, but it is by no means the only option available. Others include simply allowing an offsetting dividend deduction (the US does this), or treating the dividend as exempt income (Australia does this for certain foreign dividends).

5.35 The rebate system does not work where the company receiving the dividend is in a tax loss position. This is because the losses have to be offset against the assessable income represented by the dividend before the rebate can be calculated. Unused rebates are not refundable and cannot be carried forward, which means the benefit of the rebate is "wasted" in those circumstances. This affects reported earnings since the receipt of the dividend means that losses are extinguished and cannot be tax effected.

5.36 Controlling dividend flows to avoid this problem has long been a feature of basic corporate tax planning. Where dividend flows cannot be easily controlled, the mechanism used is sometimes referred to as a "dividend trap". This is simply a separate group company that holds the investment producing the dividends and which is managed in a way that prevents tax losses from arising – e.g. it will avoid conducting an active business and/or ensure the receipt of interest income. The ultimate holding company often fulfills this role. These simple "planning" techniques in no way involve the avoidance of tax – they do no more than avoid destroying shareholder wealth by "wasting" legitimate tax losses incurred by the business.

5.37 The rebate system works because companies within a corporate group are treated as separate legal entities, a distinction that is to be done away with under the consolidation proposals. What this would mean is that where a consolidated group is in an overall tax loss position, the dividends received would have to be offset against those losses, with the result that the losses are "wasted". None of the three alternative proposals for full entity taxation relieve this problem at either the entity or the shareholder level.

5.38 In one sense this outcome arises not so much from the consolidation proposals as from the existing system (under which the existence of tax losses can interfere with the tax-free pass through of dividends).

The fact is, however, that corporate groups can generally avoid loss "wastage" in the current system, while the consolidation proposals would render existing and legitimate tax planning arrangements ineffective. A number of groups that receive uncontrolled dividends from third parties will suffer significant financial losses unless this issue is effectively dealt with. That was surely not the intended outcome, and it is noted no revenue gains from the consolidation proposals have been included in Chapter 39.

5.39 There are three possible solutions to the problem:

Carry forward unused dividend rebates

5.40 This would simply change the loss carry forward to a rebate, with the same economic outcome on the recoupment of losses. However, this option is inconsistent with the proposal in *Platform* to abolish intercompany rebates.

Dividend deductions

5.41 Allowing an offsetting deduction to restore any losses that might otherwise be "wasted" would seem to be a simple and effective mechanism for overcoming the problem. The US uses this method, and while the US does not have a dividend imputation system, it is not clear why this point of distinction would make a deduction method unsuitable for Australia.

Exemption

5.42 A system of exemption would work just as well, provided the exempt dividends were excluded from the general rule that losses have to be offset against exempt income first (this special rule currently applies to section 23AJ exempt foreign dividends). The deductibility rules would also require modification to permit the deductibility of interest and other expenditure incurred in deriving the dividend income.

5.43 One of either the dividend deduction or exemption methods would be regarded as workable by business.

Additional foreign tax

5.44 In some cases, the CFC rules of other countries would require a different way of allocating Australian tax across the group than is presently the case. This arises because under the consolidation proposals, the holding company would be regarded as being liable for the tax. This can result in an increase in the "top-up" tax required in the home country.

5.45 The problem is referred to at page 555 of *Platform*, where the option of allowing such groups to remain outside the consolidation regime is canvassed. While we agree this is essentially a shortcoming in the CFC regimes of some other countries, a number of foreign-owned Australian groups could suffer a significant detriment as a result of the proposed consolidation regime. The only solution to this difficulty might be to allow such groups to opt out of the consolidation regime, with the grouping of losses and CGT rollover relief permitted as under the current regime. Such an option is available under the New Zealand consolidation regime.

Value shifting proposals

5.46 Chapter 29 canvasses a number of measures to prevent the creation of losses or the reduction of gains as a result of value shifting. While the consolidation proposals would address this problem within a 100% owned group, there is scope for value shifting to occur outside the consolidation regime. This can occur at either an asset or an entity level, even where transactions are at arms' length and tax avoidance is not a motivating factor.

5.47 An associate inclusive control threshold of just over 50% should apply before value shifting rules can potentially be triggered. Any incidental value shifting that might occur below that threshold should be ignored.

5.48 At the asset level, the mischief sought to be addressed by the value shifting rules is the loss or reduced gain that arises on the disposal of the loss asset. Generally, there should be no taxing point at the time of the value shift, except where the same persons control both the loss and the gain assets and the loss is realised by way of a disposal while the gain is deferred.

5.49 Value shifting that occurs as a result of the creation of rights out of existing assets may need to be separately considered, depending on whether one of either the partial realisation or threshold realisation approaches canvassed in Chapter 10 is adopted. Business would have a preference for a significant threshold before such rules came into effect, including a substantial de minimus exemption. Otherwise many ordinary commercial transactions would potentially be affected, resulting in substantial compliance problems, including valuation.

5.50 At the entity level, the loss-focused approach would be preferred by business, with the use of a cost base adjustment mechanism for reflecting value shifts. Safe harbour rules would be needed to confine these measures to circumstances where real mischief is likely to occur. What has to be avoided is a domestic style transfer pricing regime with companies having to devote substantial resources to the process of demonstrating that ordinary commercial transactions do not result in a value shift.

Other issues

Consolidation threshold of 100%

5.51 Consideration should be given to reducing the threshold for consolidation to less than 100%. Adopting the 90% threshold applicable for GST would achieve consistency from a compliance point of view – the GST regime refers to gross business income for the purpose of estimating liabilities. Para. 20.6 on page 546 contemplates some departure from the 100% ownership rule to accommodate employee share schemes and some regulatory situations – finance shares could be included as well.

5.52 While the GST grouping rules have been designed principally to simplify compliance, there should be no particular integrity concerns about reducing the threshold to 90% for income tax consolidation, given the loss duplication and value shifting measures proposed outside the consolidation regime in Chapters 28 and 29.

Joint and several liability

5.53 Joint and several liability appears to be an appropriate way of safeguarding the revenue under a consolidation regime. However, group liabilities should not continue beyond exit from the group. Otherwise a purchaser could potentially be liable for the prior year tax liabilities of the rest of the vendor group, even where those liabilities arise after the disposal of the subsidiary. Unless the liability terminates on exit, tax considerations could encourage companies to sell assets for tax reasons when it would make more sense commercially to sell the shares in the entity. Where the shares in a subsidiary are transferred to a third party for fair value, there is no value shift out of the consolidated group, and no potential mischief is apparent.

Interest allocation

5.54 One issue on which business has sought and obtained assurances in its consultations with the RBT is in respect of interest deductibility. As noted in the comments on international tax, business accepts some tightening up of interest deductibility for both inbound and outbound investment in the context of an overall rate reduction (albeit with some qualifications). However, it will be important in drafting the consolidation legislation to ensure that a pro rata system of interest allocation and quarantining is not a consequential outcome of treating the entire group as a single entity. There are some comments in *Platform* that could be interpreted as anticipating such an outcome – in particular para. 26.5 (final dot point) and para. 33.26, which refers to the "manipulation of interest allocation".

5.55 Where the tracing of funds demonstrates that no interest bearing funds have been used for the purpose of financing foreign operations, there should be no change to the deductibility of interest, subject to the base broadening measures for outbound investment canvassed in Chapter 33. In fact, if those rules are adopted the requirement to trace (which does not sit well with the concept of consolidation) could be dispensed with altogether.

Determining the cost base of entities exiting the group

5.56 While the existing value shifting rules for wholly owned groups are to be repealed, the exit models in Chapter 29 will involve considerable complexities of their own. The assets based model would also have problems on transition. No clear preference is expressed in *Platform* for one model or the other. The general preference of business seems to be for the assets based model, although that view is not unanimous.

Trust losses

5.57 The option for the treatment of entry losses understood to be preferred by the RBT (Option 1) appears to contemplate the forfeiture of trust losses on the entry of trusts into a consolidated group. This is on the basis that those losses are not groupable currently. Such an approach to trust losses would result in significant commercial damage to a number of groups, since maintaining the status quo would have given those trusts an opportunity to offset losses against future net income. Since the grouping of trust losses is not permitted under the current regime, it is suggested that transitional trust losses be quarantined on entry and be available for offset against future trust income. While this represents a departure from the proposed "all-in" approach, it is warranted on equity grounds as a transitional measure.

Existing tax losses on transition

5.58 On transition, there will be carry-forward losses within wholly owned groups that cannot be transferred because, for example, they arose during a period of less than 100% ownership. Those losses may currently be in the process of being recouped within the entity under the same business test, and absent the consolidation measures, those losses would continue to be available to the relevant entity. It would be difficult and extremely complex to devise transitional rules that provide for this process to continue within the consolidation regime, but it would be highly inequitable for those losses to be forfeited. It is therefore recommended that transitional losses that cannot be transferred should be made available to the consolidated groups.

Mechanism for consolidation

5.59 The actual mechanism for the preparation of a tax return for a consolidated group is not addressed in *Platform*. If this is not a matter on which it is proposed to legislate, it is expected that administrative arrangements will prescribe the way in which consolidation is to be achieved in practice. Two options suggest themselves, and it is recommended that either be available, depending on the preference of the taxpayer.

5.60 The first would involve firstly preparing separate tax returns for all individual legal entities that qualify for membership of the consolidated group, much in the same way as is done currently. Those returns would then need to be adjusted to eliminate intra-group transactions, and then aggregated to produce the consolidated return.

5.61 The alternative would be to use modified equity accounts that eliminate entities that do not qualify for consolidation – all those that are not 100% owned (or some lesser threshold, as the case may be) and all foreign entities. This method would entail considerable additional work, depending on the structure of the group, but could be preferred by some larger groups.

5.62 Provided both methods consistently produce the same taxable income for the consolidated group, there seems to be no reason not to permit taxpayers to choose the method that best suits their circumstances.

Loss of tax attributes on exit

5.63 In general, the proposal to leave tax attributes with the consolidated group on exit is broadly supported, with the exception of attribution account surpluses referred to in para. 26.61. There should be further consultation about the potential for significant mismatches to arise between franking credit balances and retained earnings after exit. Consideration should also be given to making a further exception to the general rule where an existing consolidated group is deconsolidated into two or three stand-alone entities. In those circumstances, there may be a case for permitting the newly created groups to each take with them a proportionate share of the consolidated tax attributes rather than have just one of them enjoy all of those benefits.

Section 6

International Tax Issues

Overview

6.1 A number of base broadening options are put forward in *Platform* – particularly in relation to interest deductibility. These proposals are supported, with qualifications, in the context of achieving an overall reduction in the corporate tax rate.

6.2 A number of positive international tax measures are canvassed in *Platform* – the refunding of excess imputation credits, the partial switch to a creditable withholding tax for foreign investors, broadening the foreign dividend account system, addressing the "triangulation" case and allowing imputation credits in respect of foreign dividend withholding tax. However, only the last of these measures does anything to relieve the impact of very high effective tax rates on foreign earnings distributed to domestic investors, and in our view it does not go far enough. The proposed corporate rate reduction does little to assist Australian based multinationals deriving most of their earnings offshore, and it is considered that business tax reform should do more to encourage this important sector.

6.3 Two critical issues for Australian based multinationals are not addressed in *Platform* at all – the urgent need to re-negotiate Australia's tax treaties with its major trading partners, and the option of allowing at least a partial credit for underlying foreign tax, combined with the streaming of foreign profits directly to foreign investors.

Summary of Conclusions

6.4 The following conclusions are drawn:

(a) There needs to be a greater commitment to re-negotiating a more efficient international tax treaty network in respect to dividend withholding tax.

(b) The problem of high effective tax rates on comparably taxed foreign earnings should be addressed by allowing a partial imputation credit for underlying foreign taxes, combined with dividend streaming of foreign profits directly to foreign shareholders where that can be achieved.

(c) Interest deductibility should not be restricted in outbound investment cases unless gearing levels have been significantly misaligned over the long term, and deductibility should be deferred rather than denied.

(d) In the case of inbound investment, a move to a total debt approach would only be supported in the context of a safe harbour fixed debt:equity ratio, supplemented by an arms' length test, an increase in the "foreign controller" threshold to 50%, and appropriate transitional arrangements for existing investment.

(e) The proposal to allow imputation credits to flow through foreign entities in receipt of franked dividends is supported.

(f) The proposal to tax the indirect transfer of Australian assets is also supported, subject to a clear "substantial proportion" rule based on fair market value, and exclusion of offshore mergers.

(g) We do not consider that comprehensive codification of the source rules is warranted, although source rules under Australian law could be better aligned with those of countries imposing foreign taxes.

(h) We support the proposed entity tax/dividend withholding tax switch, although we have some concerns about the potential impact of such a change on future treaty re-negotiations.

(i) We agree with the proposal to expand the operation of the conduit rules by permitting the flow through of more kinds of taxed foreign income. However, we do not believe companies should be required to match the proportion of foreign shareholders at the time the foreign income was derived with the proportion at the time of the flow through.

(j) Under the resident dividend withholding tax option for full imputation, there is less of a case for treating branches as being equivalent to subsidiaries. The transitional rules proposed in relation to trusts should be extended to branches.

(k) Absent a collective investment regime of the kind being put forward by the government, we would support a non-resident investment fund arrangement to maintain the competitiveness of Australian managed funds.

(l) We do not consider that codification of the existing transfer pricing methodologies is likely to enhance compliance. Nor has a case been made out for the further tightening up of the record keeping requirements for transactions that are potentially affected by the transfer pricing rules.

(m) The existing limited CGT rollover relief for controlled foreign companies should not be removed, and substantial revision of the CFC regime is required to remove unnecessary complexity and to avoid arbitrary or inequitable outcomes.

Critical Issues

Double Tax Treaties

6.5 Tax paid profits can be remitted from Australia to the US without any further imposts, while US tax paid profits suffer a 15% dividend withholding tax on repatriation. This is just one example, although a very important one, of Australia's inefficient international tax treaties with respect to dividend withholding taxes.

6.6 The option in *Platform* to allow imputation credits to resident investors for foreign withholding taxes paid by resident companies repatriating foreign profits would go some way to improving the outcome for Australian investors. However, it does not go far enough to relieve high effective tax rates, and the imposition of high dividend withholding taxes by foreign jurisdictions would continue to impact on the reported earnings of Australian based multinationals, increasing their cost of capital.

6.7 There is also a concern that this option could take the urgency out of the need to make a much more determined effort to renegotiate a more efficient international tax treaty network with respect to dividend withholding taxes.

Treatment of foreign income

6.8 Since its introduction in 1987, the dividend imputation system has had an overall positive impact on equity investment by removing the previous bias towards debt. Without the better alignment of international tax systems however, it creates a bias of its own in favour of companies having mainly domestic operations and a resident shareholder base.

6.9 The geographic spread of earnings of Australian based companies has changed significantly over the past decade, with many more companies now reporting foreign earnings as accounting for at least half of their total earnings. However, it would be wrong to conclude that the fact of this change demonstrates the treatment of foreign earnings under the imputation system is not seriously inhibiting global expansion by Australian based multinationals.

6.10 More likely, global expansion has occurred in spite of the pro-domestic bias of the imputation system. Companies have had little choice but to expand their offshore operations to achieve the economies of scale without which they cannot continue to deliver shareholder value or attract global capital. This has been a gradual process, and it is only now that more and more Australian based multinationals are faced with the prospect of distributing significant amounts of taxed foreign earnings to resident investors as unfranked dividends. Under the present system, this results in very high effective tax rates for those investors. This, in turn, impacts negatively on share prices, which results in a higher cost of capital for companies trying to compete globally.

6.11 There is a strong case for considering measures now that would encourage Australian based multinationals to remain in Australia. It is hardly consistent to be taking steps to encourage certain kinds of foreign companies to set up their regional headquarters in Australia while at the same time doing little to prevent companies that have been based here for many years from leaving.

6.12 The argument is sometimes put that the US does not seem to deter outbound investment by taxing foreign income in much the same way as Australia. Because Australia is much more reliant on international trade than the US with its huge domestic economy, it is much more important for Australia's tax regime not to impose unreasonable burdens on international investment, both inbound and outbound. In any event, the US tax system overall is more favourable in its treatment of foreign income than Australia. Under the US foreign tax credit system, there is some limited scope for offsetting high tax income against low tax income through the creditability of foreign taxes, and the US also allows foreign branch losses to be offset against domestic income. Those features are not present in the Australian system.

6.13 One way of addressing the bias against foreign earnings would be to abandon the imputation system altogether, perhaps returning to the classical system of double taxation (a possibility which is canvassed in *Platform*). Most investors regard the present system as being positive, however, and unless accompanied by significant rate reductions, business would not support such a change.

6.14 Permitting companies to stream foreign earnings directly to foreign investors would overcome many of the difficulties facing Australian based multinationals, although the associated cost to revenue would need to be factored into a revenue neutral reform outcome. Streaming could be achieved through the use of some kind of stapled stock arrangement that enables foreign earnings to flow directly to foreign investors. The amount of the dividend would be the same for all shareholders wherever situated. This method achieves two efficiencies – it preserves scarce franking credits for the benefit of Australian investors as well as avoiding foreign dividend withholding taxes.

6.15 However, streaming would only benefit corporates having the right combination of foreign earnings and foreign investors. Investors in other Australian based multinationals that have proportionately more foreign income than foreign investors would still face very high effective tax rates on the distribution of foreign earnings. It would therefore be preferable to develop a solution that also addresses the issue for other Australian based multinationals.

6.16 Two further options suggest themselves – granting an exemption of foreign profits on a flow through basis to Australian investors, or allowing credit for underlying foreign tax. The exemption option creates equity concerns since it would deliver disproportionate benefits to high-income earners. That problem could be overcome by limiting the exemption in those cases, but not without creating a high level of complexity. The exemption option is therefore not further considered in this submission.

6.17 Allowing a credit for underlying tax would represent a more comprehensive solution than streaming, although very few jurisdictions provide relief to that extent on a unilateral basis. If adopted, this measure should also extend to section 23AH branch profits. Otherwise offshore branch structures that have been set up for non-tax commercial reasons would be at a serious disadvantage.

6.18 The cost to revenue would be substantial, and unless modifications were made to such a system of credits the benefits would also flow disproportionately to high-income earners. There may be ways of containing the revenue cost of this measure, for example by limiting creditability to less than 100% of the foreign underlying tax and not making the credits refundable. The equity concerns could be addressed by limiting the creditable amount to no more than the Australian corporate rate.

6.19 While allowing imputation credits for part of the underlying foreign tax would provide a better structural solution, the option of streaming foreign profits to foreign investors has two additional advantages that are quite unrelated to Australian tax. Firstly, in some jurisdictions (e.g. the UK) investors would benefit from their domestic imputation rules if they could receive a dividend from a local entity instead. Secondly, not having to repatriate foreign earnings can result in significant savings in foreign dividend withholding tax. Those savings will be reflected in the reported earnings of the Australian based multinational.

6.20 While allowing partial imputation credits for underlying foreign tax should be the principal structural measure, there seems to be no reason to deny companies or their shareholders the non-Australian tax benefits of streaming. To the extent that streaming occurs, there would be less foreign income on which underlying tax would be available on distribution to domestic investors. Hence the cost to revenue should be about the same.

6.21 To the extent that a combination of these measures improves the outcome for shareholders, share prices should increase. This would have an offsetting impact on the cost to revenue in two ways. Firstly, increased CGT gains will directly produce additional tax revenue on the disposal of shares. Secondly, improved earnings and share prices would reduce the cost of capital, creating a preference for equity over debt financing. The resulting reduction in interest deductions would also improve revenue outcomes. The combined impact of these two changes would be difficult to measure, but they would go some way towards offsetting the total cost to revenue of the suggested measures.

Interest deductibility for Australian based multinationals

6.22 There is a proposal to limit the deductibility of interest in Australia where the Australian operations are significantly more highly geared than those of offshore controlled entities. It is understood from *Platform* and subsequent focus group discussions with the RBT that interest expenses could be disallowed where they exceed a 2:1 ratio in Australia, unless it can be demonstrated that the Australian gearing levels are not out of line with the group's global gearing levels. It is suggested a safe harbour rule should compare the Australian gearing ratio with that of an independent comparable operation.

6.23 It should be noted that foreign operations might be financed by way of interest bearing debt for reasons which are unrelated to Australian tax. Finance can sometimes be obtained at a lower cost in Australia because the group has a higher profile here, and in other cases borrowing restrictions may have been imposed under foreign legislation or under joint venture arrangements.

6.24 As acknowledged in *Platform*, in the longer term Australia's imputation system provides a strong incentive to gear up offshore operations once they become profitable, so that Australian tax can be maximised for the benefit of domestic investors. Our experience is that off shore debt increases over time, and we are not convinced the equity concerns are sufficiently strong to warrant penalising Australian companies that are trying to expand offshore. However, if interest deductibility is to be restricted in certain cases, this should only occur where gearing levels are significantly misaligned over the long term, and then interest deductibility should be deferred rather than denied.

Thin capitalisation proposals for inbound investment

6.25 The current thin capitalisation rules do not take unrelated party debt into account, although back-to-back loans and guarantee arrangements are covered. The proposal is to move to a total debt approach, using either worldwide group gearing or a fixed ratio. Of the two options canvassed on page 704 of *Platform*, business would have a preference for a safe harbour fixed ratio rather than the worldwide gearing ratio of the group, which would involve compliance difficulties. Where the safe harbour ratio is exceeded, however, an arms' length test should apply, so that interest would still be deductible if gearing levels do not exceed those of a comparable independent operation.

6.26 The threshold for a “foreign controller” under the current regime is set too low at 15%, and should be increased to 50%. In addition, the rules for calculating the amount of foreign equity need to be widened to avoid some unintended consequences that can arise under the current regime.

6.27 While it is acknowledged that moving to a total debt approach brings the Australian system more into line with other thin capitalisation regimes, applying the new regime to existing investments financed on the basis of the current rules is likely to have a detrimental effect on those projects, even with a 1 July 2000 start date. Some kind of transitional arrangements should apply to existing arrangements if the proposed changes are to proceed.

Indirect transfers of Australian assets

6.28 There is a proposal to tax capital gains realised by non-residents on the indirect disposal of certain Australian assets (through the use of interposed companies). Such a regime should only apply where there has been a substantial change in the ownership of the non-resident entity, and Australian assets make up a substantial proportion of the total assets of the entity, based on fair market value.

6.29 Canada has introduced a comparable regime, but has confined its operation to indirect disposals involving real property, resources or forestry. Consideration should be given to limiting the proposed Australian along similar, but not necessarily identical lines.

6.30 If liability is to be enforced against the asset, clear rules would need to be established to protect the interests of a bona fide purchaser. In addition, deemed disposals should not be taken to occur as a result of offshore mergers. Further consultation may be required about this proposal.

Other Issues

Source rules

6.31 There is a proposal to clarify the source rules to improve certainty for business and to improve the integrity of Australia’s tax base. While the rules governing source can be found in a variety of places (legislation, case law and tax treaties), they seem to work well enough in practice. In our view, there is no pressing need for comprehensive codification.

6.32 Adopting a substance over form approach would add to uncertainty, and if any measures were taken they should be restricted to specific rules that closely resemble those appearing in double tax treaties. It would be undesirable for Australia to set rules unilaterally in this area.

Some work could usefully be done to better match source under Australian law with the country imposing the foreign tax, which currently results in the loss of foreign tax credits. By way of example, there are still problems with Malaysia imposing withholding tax on Australian sourced service income.

Allowing franking credits to residents investing through non-resident entities

6.33 The option of allowing franking credits to Australian investors in so-called "triangulation" cases is strongly supported. Under the current system, franked dividends flowing through a non-resident company back to resident investors lose their characterisation as taxed Australian income, resulting in double taxation. The benefit to resident investors of permitting the flow-through is considered to outweigh the associated compliance costs.

Entity tax/dividend withholding tax switch

6.34 Even though the deferred company tax option is the least preferred full imputation option for business, the entity tax/dividend withholding tax switch proposed in Chapter 30 is nevertheless supported. Returns to non-resident investors would be improved under this option through their ability to obtain foreign tax credits for at least part of Australian taxes paid, and it should be considered in the context of a resident dividend withholding tax. Consideration would need to be given to the potential impact of such a change on future treaty re-negotiations. While improving the outcome for foreign investors in this fashion is desirable, it should not create an obstacle to reducing dividend withholding taxes with Australia's major trading partners, which is a far more important objective.

Expanding the operation of the foreign dividend account

6.35 We support the proposal in Chapter 31 of *Platform* to extend the scope of the current foreign dividend account beyond the flow through of foreign dividends. The new mechanism, which is described as the foreign income account, would apply to other forms of taxed foreign income such as branch profits, portfolio dividends and CGT gains. The proposal to permit an Australian holding company owned by a single foreign parent to act as the "FIA holding company" is supported, and should also be available in cases where the holding company does not own 100% of the underlying Australian investments. Otherwise the foreign investor could be severely penalised for having an on-shore holding company. There are no obvious policy reasons for such an outcome.

6.36 We do not support the proposal to require companies to trace movements in the proportion of foreign shareholders between the time the foreign income is derived and dividends flow through to foreign shareholders. It is expected that in most circumstances the degree of any change would not be large, changes would occur in both directions, and the potential mismatching that might occur would not warrant the additional compliance work involved.

Treatment of branches

6.37 We agree that if a resident dividend withholding tax is adopted as the preferred form of full imputation, there would be less of a case for treating branches as being equivalent to subsidiaries. The complexity involved in measuring dividend equivalent amounts could therefore be avoided. The transitional rules proposed in relation to trusts should be extended to branches.

Treatment of non-residents investing in Australian collective investment vehicles

6.38 Absent a collective investment vehicle regime along the lines canvassed in Chapter 16 (which is strongly supported), an alternative Non-Resident Investment Fund carve-out would preserve the current tax treatment of non-resident investors in Australian managed funds. Such measures are necessary to avoid an adverse impact on the investment by non-residents in those funds.

Transfer pricing

6.39 While it is considered there should be a legal basis for taxpayers "self assessing" transfer pricing adjustments, the formal coding of all the detailed transfer pricing methodologies is not considered necessary. The administrative guidelines have only been recently been released after extensive consultation, and these arrangements should be given time to settle. Given the extensive powers of the ATO to make adjustments and the substantial penalties that can apply in cases of non-compliance, it is difficult to see how codifying these rules would improve compliance by multinational taxpayers.

6.40 One area where the law has gone too far is in the denial of franking credits where transfer-pricing adjustments are made. The basis for the denial of franking credits is understood to be a reluctance to enable additional profits to be remitted offshore. Such an outcome is completely inappropriate for Australian based multinationals, which will have "transferred" profits to offshore subsidiaries rather than foreign parents. Those profits will ultimately be returned to Australia, so that the denial of franking credits would result in double taxation.

Record keeping requirements for transfer pricing purposes

6.41 While the notion of standardised record-keeping requirements for transfer pricing may on the face of it be appealing, the adoption of the highly onerous US-style requirements is not supported. The administrative requirements prescribed by the ATO are considered to be onerous enough, and already far exceed what would normally be retained in ordinary arms' length dealings. The additional compliance obligations that would be imposed on Australian companies are not warranted, and no case has been made out for further tightening up the record keeping rules.

CFC rules

6.42 While the anti-deferral objectives of the CFC rules are being broadly achieved, the regime needs substantial revision to reduce unnecessary complexity and to avoid inequitable and arbitrary outcomes. Australian based multinationals and their advisors have been making representations about these issues to Treasury and the ATO for some years now, and it is disappointing that this is not an area that has been earmarked for attention. The difficulties range from high compliance costs to real competitive disadvantages around restructuring, where most European countries and the US are much more flexible in allowing rollover relief for mergers and joint venture activities. Issues of this kind are best dealt with under an annual technical corrections bill, which is the process used in the US.

6.43 To make matters worse, the consolidation proposals in *Platform* contemplate the removal of the limited rollover relief available to Australian CFC's under the current system by restricting relief to the consolidated resident Australian group. Business considers that rollover relief for CFC's under the current provisions should at least be maintained, and its removal would worsen what is already a relatively uncompetitive position for Australian companies.

Section 7

Wasting Assets, Goodwill and Trading Stock

7A WASTING ASSETS

Overview

7.1 *Platform* addresses proposals aimed at adopting a simplified, fair and consistent system for taxing all wasting assets under which all expenditure on wasting assets would be deductible on a basis where tax values and economic values are more closely aligned.

Summary of conclusions

7.2 The following conclusions are drawn:

(a) There is qualified acceptance by most businesses that there should be a trade off between accelerated depreciation and a lower corporate tax rate, although this view is not unanimous.

(b) Consultation should take place so industry has the opportunity to monitor developments on such matters as the ATO's review of the effective life schedules.

(c) In respect of blackhole expenditure, there should be a general provision that ensures a write-off is available.

(d) Taxpayers should have the option of either adopting published rates (following review by the ATO as proposed) or to self assess if the taxpayer has a "reasonably arguable position" in relation to effective life.

(e) Under appropriate circumstances it should be possible to change the "effective life" on a self-assessment basis part way through the life of a wasting asset.

(f) A pooling system should be introduced for minor items below a certain threshold amount whereby taxpayers can write off the cost of such items over a certain period.

(g) It will be necessary to canvass opinion about the most appropriate legislative definition of a wasting asset.

(h) Buildings should receive specific mention as constituting a wasting asset.

(i) The definition of wasting assets should include a wider, more commercial definition of intellectual property, including technical know-how, expertise and proprietary methodologies.

(j) Deductions should be available to the person who incurs the economic loss associated with the acquisition of the asset.

(k) The cost base of wasting assets should represent the cost of the asset to the taxpayer.

(l) There is no need for any change in the existing arrangements for the commencement of the deductibility of depreciation.

(m) Whilst the removal of the balancing charge offset may align with the benchmark framework proposed, suitable allowance should be made for involuntary disposals.

(n) Appropriate transitional arrangements will be required.

Critical Issues

Blackhole expenditure

7.3 The RBT proposal to eliminate blackholes is welcomed by business. It will be important that the method implemented to achieve this is appropriate. To this end it is imperative that the blackhole expenditure be treated consistently with other wasting assets. To avoid the potential creation of new areas of blackhole expenditure, there should be a "general" provision that ensures a write-off is available. Any listing via regulation should only be implemented to indicate desired write-off arrangements for specific cases. The RBT proposal of listing blackhole expenditure risks a replication of the existing problems.

Effective life

7.4 Taxpayers should have the option of either adopting published rates (following review by the ATO as proposed) or to self assess if the taxpayer has a "reasonably arguable position" in relation to effective life. A pure self-assessment regime is considered to be too difficult administratively and hence open to disputation. At this stage it is difficult to agree to any revision of write-off rates proposed by the ATO without having the opportunity to review the updated effective life schedules. There should be a process of on-going consultation with business on keeping the schedules up to date. The opportunity must also exist for the provision of loadings in particular circumstances if warranted. It is important that effective life should recognise commercial and technological obsolescence rather than just the physical characteristics. Many in the business community support an effective life cap for very long life assets to address the impact of even low rates of inflation over long time periods.

7.5 It should also be possible to change effective life part way through the life of a wasting asset on a self-assessment basis where circumstances warrant making such a change.

Accelerated depreciation

7.6 Whilst there is broad acceptance by most businesses that there should be a trade off between accelerated depreciation and a lower corporate tax rate, that is by no means a unanimous position. Some businesses may wish to put submissions supporting departures from the effective life benchmark on the basis of wider economic benefits. There would not be opposition to limited carve outs provided they can be confined to areas where they are likely to influence behaviour and when the tax system is considered to be the most appropriate vehicle for encouraging such activities.

Items costing less than $300

7.7 The proposed capping of $10,000 of the aggregate of immediate write-offs under the “less than $300” rule only adds an unnecessary degree of arbitrariness. Clearly arrangements to sell items of plant that have been depreciated to below $300 into a special purpose company in order to obtain an immediate write-off would concern the ATO and RBT. However, such matters should be addressed through the use of Part IVA. Similarly, the scenario of a taxpayer with a significant number of small value items - as highlighted by the RBT team at focus group meetings - would best be addressed by applying a test of materiality rather than having a capped amount which is relatively disadvantageous to larger taxpayers. The solution may be to introduce a “pooling” system whereby taxpayers may pool all minor items below a certain threshold amount and then write them off over a certain period. Determination of the appropriate threshold and corresponding write-off period should be subject to further consultation. Such consideration should consider the introduction of a sliding scale of threshold limits with varying write-off periods allowing taxpayers to adopt an option appropriate for their capital asset base. Under a pooling system disposal proceeds would be applied against the depreciation claim.

Other Issues

Definition of "Wasting Asset"

7.8 Whilst it may be appropriate to consider a definition of wasting assets along the lines of the definition of depreciable assets in Australian Accounting Standard AASB 1021, it would be necessary to canvass any proposed definition prior to its acceptance as the benchmark. The need for this is clearly illustrated in the recent software legislation which was brought in to ensure that blackholes were avoided and in fact created a blackhole that arguably did not previously exist.

7.9 For greater certainty buildings should be acknowledged as representing a wasting asset, possibly with effective life being dependent on the type of building involved. Similarly, to ensure certainty the definition of wasting assets should include a wider, more commercial definition of intellectual property, including technical know-how, expertise and proprietary methodologies. The effective life of such items needs to be considered but would be closer to 5 years rather than the 15 years assigned to trademarks, patents and registered designs.

Entitlement to deduction

7.10 Business supports the concept that the deduction should be available to the person who incurs the economic loss to derive assessable income and has an economic interest in the asset. This would eliminate the current problem of deductions being available to legal owners only.

Cost base

7.11 The cost base of wasting assets should be based on the cost of the asset to the taxpayer (this would change the current treatment of buildings). It is also accepted that to be equitable, where an asset has been gifted to a taxpayer, the appropriate tax value would be the market value of the asset. At the same time expected disposal receipts should not reduce the cost base. Such an approach is arbitrary and too dependent on estimates and projections. If it were to be adopted it would provide too much uncertainty and be subject to disputation.

Commencement date

7.12 There is no need for any change in the existing arrangements for the commencement of the deductibility of depreciation (write-off). It should remain as currently stated: "installed ready for use or held in reserve".

At the same time current special industry rules may be retained (e.g. long lead-time projects and the mining industry), subject to submissions from relevant parties.

Adjustments for subsidies received

7.13 If a subsidy can be directly related to the purchase of a specific asset, a reduction of the cost base would appear appropriate. Where a subsidy is provided in respect of an entire project it should be apportioned over the separate assets comprising the project and offset against their cost.

Balancing charge issue

7.14 In general we would support the removal of the current balancing charge offset to more closely align with the benchmark framework proposed. However, an exception should be introduced for involuntary disposals of assets (e.g. destroyed in a fire). Taxpayers often encounter severe cash flow problems in these circumstances with insurance recoveries generally falling short of the replacement cost of the assets. Any changed arrangements should only apply to assets purchased after the operative date.

Transitional Issues

7.15 Transitional measures would need to cover such matters as:

- grandfathering for long lead-time projects which have been committed to (i.e. assets may continue to be acquired under the existing rules after the introduction of relevant legislation);
- existing arrangements should remain for wasting assets currently held at transition;
- any adjustments to spare parts or partly completed contracts would need to make appropriate adjustments for opening balances.

7B GOODWILL

Overview

7.16 *Platform* asks for input on whether acquired goodwill should be depreciated or whether the current treatment should be maintained.

Summary of conclusions

7.17 In line with the proposed approach to writing off wasting assets acquired goodwill should be written off over a set period of time.

Critical Issues

7.18 From the perspective of wanting to ensure Australian taxpayers maintain international competitiveness it would be desirable to have a regime that provides for the write-off of acquired goodwill as this is available to many of our foreign competitors in their own jurisdictions. It would also help arrest an existing perception of bias towards taxpayers with hard assets rather than intangibles such as goodwill. It is clear that the RBT has not been in a position to cost this option, and further work will be necessary. In line with the general principle of writing off wasting assets, all acquired goodwill could be written off over a period of , say, 15 years as in the US.

7C TRADING STOCK

Overview

7.19 *Platform* puts forward a reform strategy aimed at developing a treatment of trading stock that would result in consistent valuation for tax purposes.

Summary of conclusions

7.20 The following conclusions are drawn:

(a) While a consistent and flexible valuation regime for trading stock is desirable, it should not incorporate non “trading stock” items such as consumable stores and spare parts.

(b) The basis of the valuation of trading stock should be consistent and taxpayers should be allowed to select the basis of valuation for all their stock.

(c) It is considered inappropriate to recognise estimated profits and losses in relation to partly completed contracts for the provision of services as this would effectively include both unrealised gains and losses in taxable income.

Critical Issues

Basis for valuation of trading stock

7.21 In our view the basis for the valuation of trading stock should be consistent and taxpayers should be allowed to select the basis of valuation for all their stock. This basis would best be met by Option 3, which allows taxpayers to select one of the current options for all stock and only allows a change in the method selected if the taxpayer can make a sound case based on non-tax considerations.

Consumable stores and spare parts

7.22 Consumables and spare parts are not in the nature of trading stock. Expenditure on such items should continue to be allowed on an "incurred" basis which is the appropriate matching from a taxation perspective because it constitutes a recurrent expenditure on items to be used in the foreseeable future. A proposal to bring such expenditure under a trading stock regime would ignore the character of the expenditure.

Standing crops

7.23 The proposals promoted in *Platform* are likely to have an enormous impact on particular industries and the RBT should carefully consider submissions made by industry groups on these matters.

Mining and Resources

7.24 Further consideration is also necessary of the impact of proposed changes to the mining and resources industries. Industry submissions need to be addressed bearing in mind current arrangements and relevant international competitiveness.

Partly completed contracts for the provision of services

7.25 We consider as inappropriate the proposal raised in this area of recognising estimated profits and losses to the extent it effectively includes both unrealised gains and losses in taxable income. In accordance with the proposed approach detailed in the section dealing with taxation of financial assets and liabilities, a realisation regime should be adopted. Further consultation on this matter would be appropriate.

Section 8

Taxation of Financial Assets and Liabilities, Rights and Leases

8A FINANCIAL ASSETS AND LIABILITIES

Overview

8.1 The general approach being considered contemplates:

- adoption of an accruals approach where practical;
- allowing an elective mark-to-market approach;
- taxation of other assets and liabilities on realisation.

8.2 Business is generally supportive of the approach proposed, subject to various issues raised below and subject to resolution of specific matters raised by the banking and mining industries.

Summary of conclusions

8.3 The following conclusions are made:

(a) The overall structure of the proposals put forward by RBT is seen as providing a good framework for establishing a workable model for the taxation of financial assets and liabilities.

(b) A number of key areas, including those detailed below, remain to be finalised, together with an appropriate timetable for implementation to allow for proper consultation, discussion and resolution of issues.

(c) It is vital that the debt/equity distinction is clear and certain and maintains symmetry between holder and issuer.

(d) To achieve certainty (a key design principle) it is critical that the "facts and circumstances" test be based on objective rather than subjective criteria.

(e) Business considers it necessary for appropriate hedging rules to be introduced.

(f) Hedging rules need to allow for hedging strategies whereby a rolling series of hedge transactions are used to hedge a longer dated underlying exposure.

(g) The use of financial assets and liabilities is an integral and fundamental part of the conduct of most businesses and to quarantine losses on such instruments from the general calculation of taxable income of business operations is contrary to the underlying principle of RBT on tax neutrality.

(h) Internal deals (which often involve large asymmetric accounting results in any given year but which will ultimately reverse) are recognised for financial accounting purposes as a proxy for revaluation of external assets/liabilities. We would expect to be involved in future discussion on this matter.

(i) The safeguards detailed in option 1 (transaction basis) are too onerous and further consultation on them is warranted.

(j) It is important that a definition of realisation is incorporated in the Act and/or the hedging rules.

(k) We are concerned about the RBT approach on perceived soft currency exploitation and consider this matter should be addressed by anti-avoidance rules, if at all.

Critical Issues

Framework – Debt/Equity distinction

8.4 Whilst business is generally supportive of the latest proposals, it is essential that the framework developed is appropriate and suitable for addressing ongoing issues and developing financial markets. Initially it is vital that the debt/equity distinction is clear and certain and maintains symmetry between holder and issuer. In considering this issue we refer back to the Financial Arrangements Issues Paper released by Treasury and the ATO in December 1996. In that Paper, Chapter 6 outlines a general definition of debt and a further “facts and circumstances” test against which all financial instruments must be assessed. It is important that this test be based on objective rather than subjective criteria. In this way any instrument possessing the relevant attributes would be clearly debt, and all other instruments would be equity. Accordingly, in approaching this test, the following considerations should be kept in mind:

- A precise definition of debt for all purposes of the Act, as that term is commonly understood, is essential
- debt and equity should be mutually exclusive.

8.5 To achieve certainty (a key design principle) it is critical that the “facts and circumstances” test be based on objective rather than subjective criteria.

Hedging Rules

8.6 Business considers it necessary for appropriate hedging rules to be introduced. On the basis that assets/liabilities are used to assist in managing economic risks, hedge transactions need to be taxed in a way that matches both the timing and character (revenue/capital) of the tax result of the hedge transaction and the underlying transaction. They must be broad enough to cover, inter alia, the hedging of:

- Financial assets and liabilities
- Non financial assets, such as investments in overseas subsidiaries
- Anticipated sales revenues and business expenditures.

8.7 The hedging rules also need to allow for hedging strategies whereby a rolling series of hedge transactions are used to hedge a longer dated underlying exposure. Such strategies may be commercially necessary due to the absence or illiquidity of long dated hedge products. In accordance with paragraph 6.62 of *Platform* it is proposed that hedging treatment will only be afforded where requisite documentary and objective criteria are satisfied. It is suggested that the rules will need to be more flexible than those set out in *Platform*. It should be recognised that corporate treasuries are generally under significant restrictions and can often only hedge underlying assets. Bearing in mind those restrictions, an appropriate risk bases approach could be to rely on internal controls and the adherence of proper risk management regimes.

Quarantining of losses

8.8 The RBT is proposing the quarantining of losses for financial assets and liabilities taxed on a realisation basis and for those losses to be available only for offset against gains on similar assets and liabilities. It must be stressed that the use of financial assets and liabilities is an integral and fundamental part of the conduct of most businesses. To quarantine losses on such instruments from the general calculation of taxable income of business operations is contrary to the underlying principle of RBT on tax neutrality. Any concerns held on the ability of taxpayers to accelerate losses and defer gains should be dealt with in a different way.

Internal deals/internal hedges

8.9 Some business sectors have expressed concerns about the failure of *Platform* to recognise internal deals and internal hedges. Internal deals (which often involve large asymmetric accounting results in any given year, but which will ultimately reverse) are recognised for financial accounting purposes as a proxy for revaluation of external assets/liabilities. We are aware that separate submissions are being made on this specific topic and would appreciate being involved in future consultation on this issue.

Safeguards/restrictions

8.10 The safeguards detailed in option 1 **(**transaction basis) are too onerous and will impair taxpayers' ability to utilise this approach when electing a mark-to-market method. Further consultation on the safeguards is required.

Definition of realisation

8.11 It is important that a definition of realisation is incorporated in the Act and/or the hedging rules. Any definition should be based on economic substance rather than legal principles. For example, rollovers of hedges that relate to an underlying asset may represent a legal realisation but not an economic realisation, which occurs on the disposal of the asset and the termination of the hedge.

Soft currency concerns

8.12 We are concerned about the RBT approach on perceived soft currency exploitation and consider this matter should be addressed by anti-avoidance rules, if at all. The additional compliance costs that would be imposed through a requirement to bring to account forward premia/discounts separate to the underlying gain/loss on spot rates should not be imposed on taxpayers other than in an anti-avoidance context. There are valid commercial reasons why taxpayers enter into transactions in so called "soft" currencies – for example, a borrowing in that currency might be undertaken to hedge underlying assets held. The underlying presumptions made in *Platform* are highly questionable and can only be justified on the basis of hindsight. This is not an appropriate approach where certainty is sought.

Transitional Issues

8.13 Any changes to the taxation rules for financial assets and liabilities should only apply to financial assets and liabilities contracted for after the commencement date of the rules with an option available to bring all financial assets and liabilities that exist within the rules.

8B RIGHTS AND LEASES

Overview

8.14 The RBT approach is premised on the basis that the current taxation of rights and leases does not tax income on a consistent basis due to the complex mix of different rules based on legal form rather than substance. This creates inconsistent outcomes and disadvantages some taxpayers while others receive significant tax advantages. Complex arrangements also exist in relation to tax exempts.

Summary of conclusions

8.15 The following conclusions are drawn:

(a) Generally business supports the continuation of the existing taxation treatment of leases, although we would support measures to discourage the assignment of lease tails.

(b) It is considered that such draconian provisions as section 51AD are no longer required. They act as an impediment to commercial business arrangements and we strongly encourage their removal.

(c) There is a requirement for clear and precise rules that should assist taxpayers to determine if they have the requisite economic interest in a physical asset for capital allowance purposes.

(d) The depreciation of a right should be similar to that for a physical asset by allowing the right to be written-off over its effective life. Full consideration must be given to technological obsolescence in the estimation of the effective life as the basis for write-off of rights.

Critical Issues

Sale and Loan Approach

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

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

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

Transfer of tax preferences

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

Splitting depreciation claims

8.20 The splitting of depreciation claims between the lessee and the lessor would result in an extremely complex regime and increase the compliance burden on taxpayers since the lease payments would presumably need to be allocated in some manner into taxable and non-taxable components.

Section 51AD and Division 16D

8.21 It is clear that the existing provision of section 51AD and Division 16D create significant impediments to normal business transactions. The removal of these provisions would result in a more consistent and simplified approach to leasing. With the high levels of asset privatisation occurring in Australia, it is considered that such draconian provisions as section 51AD are no longer required, are an impediment to commercial business arrangements and we strongly encourage their removal.

Ownership of rights

8.22 There is a need for clear guidance about when a business has a sufficient degree of ownership in a physical asset to be entitled to a depreciation deduction under the revised capital allowance regime for physical assets. This issue is important because a taxpayer needs to know whether expenditure incurred should be depreciated under capital allowances for physical assets or under a different provision, such as the proposed rights regime.

8.23 The introduction of the concept of economic ownership in a physical asset and the concurrent introduction of a general regime for rights in an asset could create confusion about the appropriate provision under which tax relief should be sought. Accordingly, there is a requirement for clear and precise rules that should assist taxpayers to determine if they have the requisite economic interest in the physical asset for capital allowance purposes (refer paragraphs 1.15-1.17 of *Platform*).

Write-Off of rights

8.24 We would advocate that the deprecation of a right should be similar to that for a physical asset by allowing the right to be written-off over its effective life. It is important that full consideration be given to technological obsolescence in the estimation of the effective life as the basis for write-off of rights. This is because many rights pertaining to technological-based knowledge are subject to a very high degree of obsolescence.

8.25 The adoption of a legal life basis for depreciation of all rights is inappropriate as it fails to recognise that many rights economically expire before the end of their legal life. A legal life basis of write-off would also create a major distortion between the write-off of physical assets and rights, and could fail to achieve the aim of more closely aligning tax values with economic values.

Transitional Issues

8.26 Any existing lease arrangement should be allowed to run its term as should fixed term contracts if these proposals were to be adopted.

Section 9

Taxation Of Capital Gains

Overview

9.1 *Platform* proposes a number of changes to reform capital gains tax (CGT). In general, we support the suggested reasons for reforming CGT which are to:

- stimulate savings and investment;
- reduce lock-in effects from high CGT rates and improve capital mobility;
- encourage patient capital;
- reduce the bias against investment in high-risk areas;
- potentially remove impediments from some forms of foreign investment into Australia; and
- improve CGT concessions in the area of small business.

9.2 In addition we would strongly recommend that changes to CGT should not be made based on sectional interest grounds but should be based on the fundamental principle of being in the national interest.

9.3 Whilst the proposals to reduce CGT do not have to be revenue neutral within the CGT changes themselves, additional revenue needs to be found to pay for the changes. Within CGT, a proposal is made to eliminate indexation and CGT averaging to help pay for the increased concessions.

Summary of Conclusions

9.4 We support the following CGT reform measures:

(a) CGT rate relief for individuals in the form a tapered rate scale;

(b) Scrip for scrip rollover relief extended to all entities taxed as companies with appropriate safeguards to prevent abuse, and clearly defined boundaries;

(c) Consideration of a range of other reorganisation type transactions as qualifying for CGT rollover relief along the lines of US relief provided in their tax law;

(d) No specific industry relief except in limited circumstances to allow certain tax exempt foreign pension funds to invest free of CGT in designated venture capital funds/investments;

(e) Carryback of capital losses for 3 years for assets acquired post 1 July 2000;

(f) Removal of indexation and averaging in order to finance the above measures.

Critical issues

9.5 An analysis of the particular CGT measures dealt with in the *Platform* document are discussed below.

Increased CGT concessions

A 30% capped rate for individuals/reducing tax rates uniformly by 20%

9.6 With the reduction in personal income tax rates whereby it is estimated approximately 80% of all taxpayers would be on a tax rate of 30% or less, it may be possible to cap CGT at the 30% rate. Alternatively, all rates could be reduced uniformly, for example, by the same percentage, say 20%.

9.7 Neither of these CGT measures would adequately stimulate investment in accordance with the principles set out in the overview, particularly in the area of patient capital.

9.8 It is acknowledged that a high proportion of further investment would most likely come from higher rate taxpayers who have the greatest capacity to respond to the measures by increasing savings. However, under the 30% cap regime there would be insufficient stimulus for long-term investment, particularly in high-risk areas such as new technology companies.

9.9 Under the second alternative where rates are reduced by 20%, the reduction in marginal rate is inadequate in encouraging long-term investment in high risk ventures.

A stepped CGT rate

9.10 A stepped rate approach is considered to be the more effective mechanism which reduces CGT rates for individuals on the sale of long-term assets. Both the UK and US models are outlined on pages 291 and 292 of *Platform*. We concur with the principles behind both regimes and believe that the adoption of a similar model would attract long-term investors and boost Australia's economic growth.

9.11 It is noted that any concessional treatment of capital gains over other income could produce the effect of switching activity from revenue generation to capital generation to reduce tax. However the stepped rate approach is least prone to this compared with other less desirable options as the reduced rates of tax could be made to apply after an initial phase in period of say 2 years.

9.12 The design features of the stepped approach are critical. In particular the stepped approach will need to cater for:

(a) That assets held short term say up to 18 months or two years should bear marginal tax rates to stop speculation and encourage a minimum holding period.

(b) After the initial period a reduced rate should apply to bring the rate down to or below the entity tax rate to avoid locking investments in companies where a lower rate would apply from day one.

(c) The number of steps should be kept to a minimum to avoid too much complexity.

(d) Rules regarding the offset of capital losses against capital gains on assets falling within different age bands need to be developed to prevent losses being offset against the highest rate capital gains. For example, it may be possible to allow capital losses to be offset in full against gains from assets within the same age band. However, only a proportion of the losses from long term asset sales would be offset gains on shorter term assets e.g., 30/47 of the loss from an asset sold within a 30% tax bracket could be offset against a gain taxable at a 47% rate.

(e) The CGT rate applicable for the period of ownership would be a maximum rate so that if the person's marginal tax rate was lower, the lower rate would apply.

$1,000 CGT exemption

9.13 A $1,000 CGT exemption threshold is proposed to apply annually for individuals, subject to a possible anti-avoidance provision for year end sales of assets to achieve a gain subject to the $1,000 exemption and immediately buying back the same asset post year end. Such a proposal is not supported on the basis that it would not appear to meet any of the objectives set out in the overview above. Rather it is merely seen as a hand out without encouraging favourable economic behaviour. Nor would increasing the threshold to a higher level of say $5,000 achieve any real benefits in our view.

Scrip for scrip rollover relief

9.14 Scrip for scrip rollover relief is proposed where shareholders are issued shares in a listed company in exchange for their shares in another listed company on a take-over or merger. There are good arguments to extend scrip for scrip rollover beyond publicly listed companies to widely held non-listed public companies and even private companies to encourage growth and efficiencies which come with economies of scale.

9.15 However, it would seem that extension of scrip for scrip relief beyond listed companies is not favoured by the RBT because of potential avoidance situations that could exist in an environment that is not transparent. This submission considers that appropriate safeguards can and should be enacted to deal with possible avoidance situations while allowing an extension of scrip for scrip rollovers to all entities taxed as companies. Clearly there is no economic reason to limit relief to listed companies. Moreover, smaller non-listed companies have greater barriers to growth, including access to debt and equity finance, which would be overcome to some extent with this proposal.

9.16 Scrip for scrip rollovers are permitted in many other countries such as the US and have been a driver to economic growth in those countries. Extension of those rules to Australia would be another plank in the process of allowing Australian companies to compete on a world stage through having the ability to grow.

9.17 There are a number of boundary issues that are important with this measure as follows:

(a) Whether 100% of the target company has to be acquired or whether an 80% control requirement would be sufficient as applies under US tax law.

It is considered that an extension to 80% situations may be warranted to allow take-overs or mergers to proceed with an element of comfort that not 100% of the target has to be acquired. Otherwise, commercial transactions may not proceed because of the fear that a minority will hold out and render the majority selling shareholders taxable.

(b) Whether a combination of cash and non-cash consideration paid to selling shareholders would render the entire transaction taxable or merely the cash component.

Limiting rollovers to share only transactions is consistent with all other rollovers currently in the tax law.

(c) Whether the CGT rollover would be mandatory or elective.

A mandatory rollover regime would be acceptable.

(d) What the international boundaries to the exemption should be.

Boundaries consistent with current CGT rules need to be applied in relation to the taxation of non-residents so that shares can be rolled over so long as they remain within the CGT net and cannot be rolled over out of the CGT net.

Other reorganisation transactions.

9.18 Beyond scrip for scrip rollovers, there is a range of commercial transactions that warrant consideration of rollover relief. These transactions include: (1) where substantially all the assets of a corporation are acquired in exchange for shares, (2) de-merger type transactions where operating divisions/subsidiaries are spun off to shareholders out of a group (this includes spin-offs, split-offs and split ups as provided in US tax law), (3) recapitalisations of companies in certain circumstances e.g. where there are exchanges of debt for shares, shares for shares and debt for debt.

9.19 Consideration of these additional transactions should be made to determine if rollover should apply. Limitation of a rollover to scrip for scrip transactions is generally considered too narrow.

Targeted concessions for certain types of investment

9.20 *Platform* raises the possibility of targeted concessions for particular industries including venture capital and high tech companies that are penalised by Australia's treatment of capital gains.

9.21 In general, direct CGT relief for such industries on a broad basis is not considered appropriate for a number of reasons including:

(a) the difficulty in defining the size of company that concessions should be limited to and the problem of favouring some companies over others;

(b) problems in defining the technology that should be targeted;

(c) avoiding picking winners;

(d) potential to abuse of concessions provided.

9.22 A case however can be made out that a significant boost to the Australian venture capital markets and in turn high-tech companies would be made by allowing foreign pension funds from the US to invest CGT free into Australia. Tight controls would need to be developed to prevent CGT free investment being made in non-approved areas. Capital losses on such investments would not be allowable. On this matter we defer to other submissions, including that being made by the Tax Technology Alliance which we understand is dealing with this matter in more detail.

Capital loss quarantining

9.23 *Platform* proposes a number of measures to counter the problem that capital losses can only be offset against capital gains thus creating a bias towards some forms of investment. A range of options is considered, including a carry back of capital losses to offset earlier capital gains.

9.24 We support allowing capital loss carrybacks for a period of 3 years, but limited to assets acquired after 1 July 2000 to restrict the revenue impact. This measure would be designed to offset the quarantining effect on capital losses and the fact that capital losses may not be able to be used for many years.

Offsetting measures

Removal of CGT indexation and averaging arrangements

9.25 Removal of these two concessions has been proposed as a way of clawing back revenue given up under the above tax concessions. In the case of averaging it is argued that this is being inappropriately exploited through use of the tax-free threshold and there is a good case for scaling this back. With indexation, it would appear that while this provides CGT relief to corporations, superannuation funds and individuals, it is not a major driver of investor behaviour.

9.26 Removal of indexation and averaging is supported provided sufficient measures to encourage favourable investor behaviour as outlined above are enacted.

Section 10

Fringe Benefits Tax

Overview

10.1 The RBT proposals consider the following options in respect of FBT:

- addressing equity issues by taxing fringe benefits in the hands of the employee;
- improving efficiency, and to generate additional revenue, change the ‘concessional’ statutory formula for car benefits; and
- consider different treatments for entertainment and on-premises car parking fringe benefits, at some cost to revenue.

10.2 The current review represents an opportunity to establish a sound conceptual basis for the taxing of fringe benefits rather than continue to introduce ad hoc grafts on to the present system. The recent FBT Reporting Bill has added another unnecessary layer of complexity to the FBT regime by going well beyond the equity concerns it seeks to address.

10.3 The opportunity now exists to refocus the operation of FBT back to its original purpose. FBT should only be imposed on benefits which represent non-cash forms of remuneration.

10.4 Business is not of one mind about transferring FBT liability back to employees. This is so because to a large extent the provision of fringe benefits is “packaged salary” and the additional cost to employers for administration, whilst high and unwarranted, is already in place. A change to this approach is also seen as potentially creating industrial relations problems.

Summary of Conclusions

10.5 The following conclusions are drawn:

(a) The legislation should be revamped with the inclusion of a “remuneration test” to bring it into line with its original intention.

(b) The proposal to revert to a non-deductible/non-FBT scenario for entertainment has strong support from business.

(c) The proposed exclusion of workplace car parking is a welcome development for reporting purposes.

(d) Business support for the alignment of the FBT and income tax years would be subject to it being optional.

(e) The current statutory rules applying to FBT on cars can be considered concessional and we would support a reduction in the level of the concession to finance the proposed change to the entertainment arrangements.

Critical Issues

Appropriate Base for Taxing Fringe Benefits

10.6 The rationale behind the introduction of FBT was to ensure all forms of remuneration were taxed on a consistent basis. FBT was to be imposed on benefits that represented non-cash forms of remuneration.

10.7 However, the scope of the *FBTAA* goes well beyond the original objective by adopting an extremely wide definition of "fringe benefit", such that virtually everything provided by an employer to an employee represents a "fringe benefit", (see section 136(1) of *FBTAA*). This had the effect of the legislation applying to expenditure incurred or reimbursed, such as the provision of after-hour taxi travel for safety reasons or the participation in business entertainment. Expenditure on taxi travel has since been removed, following the "Cost of Compliance" review.

10.8 Now would seem an appropriate time to redress the excessive compliance costs imposed on employers and to refocus the legislation back on its original objectives. The Review should consider the adoption of a "remuneration test" to determine whether a fringe benefit was provided to employees in lieu of cash salary. The incorporation of such a concept into the legislation is considered to be quite achievable.

10.9 A remuneration test would reflect the original objectives of FBT by only applying to benefits represent non-cash remuneration - i.e. benefits which can be "cashed out" or taken in some other form. The test could be incorporated into the definition of "fringe benefit" in section 136(1) of the *FBTAA*. This would be an additional test to be met in determining whether a fringe benefit was provided by the employer.

10.10 An acceptable definition of "remuneration" could be established together with a listing of often provided non-cash benefits as well as a specific reference to include similar items. Any listing should not be exhaustive as this would be too restrictive. Regard could also be had to the terms of section 26(e) of the *ITAA (1936)* which taxes non-cash benefits.

10.11 In relation to the ability to cash-out benefit, this criterion would assist in determining whether the benefit represents remuneration. However, the employer policy would not be the sole determinant as to whether the benefit could be cashed-out, so that where an employer specified that remuneration must be taken in a particular form, such as by way of a company car, the inability to actually exchange this benefit for salary would not alter the benefit being considered as remuneration.

10.12 The adoption of the remuneration test would restore taxpayer confidence in the operation of FBT, reduce the complexity of the legislation and reduce the excessive FBT compliance burdens. The impact on revenue is unlikely to be material – most FBT revenue is accounted for by only a few benefits, and these would still be caught. This approach would be consistent with the RBT proposal of generally adopting a system of specific inclusions.

Treatment of entertainment

10.13 The proposal to revert to a non-deductible/non-FBT scenario for entertainment has strong support from business. The current treatment clearly fails to recognise not only that entertainment is a legitimate business expense, but often does not represent an actual benefit to employees involved. The RBT proposal to have a “carve-out” for entertainment that forms part of remuneration (as discussed in focus group meetings with the RBT) demonstrates that a remuneration test is considered achievable.

Treatment of on-premises parking

10.14 The proposed exclusion of workplace car parking would be a welcome improvement for reporting purposes.

Alignment of FBT and income tax years

10.15 A survey carried out by the CTA in early 1996 provided the following results:

- generally June balancing companies were happy with the current arrangements and felt that year end statutory accounting requirements would make it difficult to concentrate on FBT returns in July. As an alternative there was a degree of support for making a fourth instalment on 28 July if lodgment of return could be extended to 28 September.

- workload requirements are a major consideration and it should be borne in mind that as well as year end accounts other “tax related” returns required in July/August include:
  - payroll tax returns
  - workers compensation
  - group tax reconciliations

- it would be inappropriate for companies to have to engage extra staff or require extensive overtime due to an uneven flow of administrative requirements. Unfortunately this is currently the case with December year-end companies so that the introduction of Substituted Accounting Periods for FBT may be the most appropriate approach.

- in considering transitional arrangements it will be necessary to ensure fairness and the implications to such matters as:
  - interest rate benchmark figures
  - reduction in base value of car for Car Fringe Benefit calculations
  - calculation of statutory formulae for Car Fringe Benefits.

10.16 This survey was carried out prior to the introduction of the FBT Reporting Bill, which clearly further complicates the issue. As such business support for the alignment of the FBT and income tax years would be subject to it being optional.

Concessional treatment of cars

10.17 The current statutory rules applying to FBT on cars can be considered concessional and we would support a reduction in the level of concession to finance the proposed change to the entertainment arrangements.

Section 11

Anti-avoidance provisions

Overview

11.1 We acknowledge that many of the structural and design proposals in *Platform*, if adopted, would overtake the need for specific anti-avoidance rules. There needs to be a debate about the need for anti-avoidance rules, but if they are to be retained to support the general law, any purpose threshold should be no less than "sole or dominant". The introduction of a "principal effect" test (as in *A New Tax System (Goods and Services Tax) Bill 1998)* would create enormous uncertainty for business. Such a test could also be perceived as being open to arbitrary application by the revenue authorities. The existing laws are already quite effective, and recent court decisions have interpreted the legislation fairly widely.

Summary of Conclusions

11.2 The following conclusions are drawn:

(a) Specific anti-avoidance rules should be removed wherever possible once the structural changes contemplated in *Platform* are implemented.

(b) There has to be a debate about the need for general anti-avoidance rules, having regard to the new structural approach proposed for business tax.

(c) Legislative measures should be proportionate to any perceived mischief from avoidance activities, and anti-avoidance rules should not seek to tax every last dollar.

(d) All anti-avoidance rules should be based on purpose, with a common "sole or dominant" threshold.

(e) A "principal effect" test, or any other test which has a threshold that is lower that "sole or dominant purpose" is highly inequitable because it could potentially apply to commercial dealings where tax minimisation is not a driver, and creates uncertainty for business.

(f) The existing provisions of Part IVA need to be modified to limit their application to circumstances which are blatant, artificial or contrived.

Critical Issues

Underlying philosophy

11.3 A threshold question is whether general anti-avoidance rules are required at all. Some countries (e.g. the UK) have decided to rely principally on the courts to give effect to underlying tax policy in interpreting legislation. While the Australian courts have not generally had a tradition of being interventionist in tax matters, this could be regarded more as a product of the incoherent nature of the existing tax laws than any reluctance on the part of the judiciary to adopt such an approach. It is difficult to give effect to underlying principles where none can be discerned.

11.4 The *Platform* proposals contemplate moving to a much more structured approach to the design of the business tax system, using national objectives and framework principles. Such an approach should result in a much more coherent system of tax laws, from which judges could more readily establish purpose.

11.5 While the need for specific anti-avoidance rules would be substantially removed where the tax system is based on clear principles, there also needs to be a debate about whether there is still a role for general anti-avoidance rules under such a system. Business and the revenue authorities may want to consider whether the uncertainty created by the approach of an interventionist judiciary in interpreting core provisions is to be preferred over the uncertainty created by the administration and interpretation of general anti-avoidance rules.

11.6 Another broad issue is the need to strike the right balance between achieving the objective of ensuring that all taxes properly due are in fact collected, and the need to avoid framing tax rules that are unduly intrusive and far-reaching. A system that seeks to tax every last dollar regardless of the high compliance costs and complexity imposed by way of collateral damage on the majority of highly compliant taxpayers is not serving the best interests of the wider community. A certain degree of leakage has to be tolerated so that the business system has some room to breathe. The legislative response to potential tax avoidance activities should therefore be proportionate to the perceived mischief.

Scope and design of a general anti-avoidance rule

11.7 If a general anti-avoidance rule is to be maintained, it should clearly be a provision of last resort, and not a primary taxing provision. The key trigger for its operation should be one of purpose rather than the economic effect of an arrangement. While it may be true that purpose can be an elusive concept, it is not an unfamiliar one for Australian courts, which have proved to be more than capable of dealing with such issues in tax and other areas of the law.

11.8 The difficulty with an economic effect test is that, by its nature, it is capable of applying in circumstances where commercial arrangements are entered into without any regard to tax minimisation. Under a "principal effect" test there may be scope for arguing about the weight to be given to one outcome or another. However, the fact remains that it would be open for a court to rule against a taxpayer even where an arrangement is entered into for commercial reasons that are quite unrelated to tax.

11.9 Depending on how vigorously such a test is administered by the revenue authorities and interpreted by the courts, an economic effect test could be tantamount to a "tax maximization" rule. Strictly applied, it could require taxpayers when confronted with alternative ways of structuring commercial arrangements to choose the option that maximizes the payment of tax.

11.10 The revenue authorities might provide guidance on how such provisions will be administered in practice by saying they will only be applied in what they regard as extreme cases. Likewise, the courts might choose to read down the provisions to exclude arrangements that they consider are clearly commercial and only have the incidental effect of reducing the incidence of tax.

11.11 However, any law that requires the revenue authorities and the courts to ignore the plain words of the legislation in order to achieve what in their view are reasonable outcomes is bad law. It would create enormous uncertainty for taxpayers, and could undermine confidence in the revenue authorities if there is a perception by taxpayers that their powers are excessive and are exercised in an arbitrary fashion.

11.12 It follows from the foregoing that the BCA/CTA would be strongly opposed to the introduction of a "principal effect" test for any income tax anti-avoidance rule. We would also argue that any test which relies on a purpose that merely includes the purpose of tax avoidance or which applies where tax avoidance is more than an incidental purpose is inappropriate. Such tests would create uncertainty and could apply to any commercial arrangement where tax avoidance was not the driving factor.

11.13 We do not agree with the proposition that a "sole or dominant purpose" test sets too high a threshold, and would leave the way open for a wide range of nefarious activities. To the contrary, the limited number of decided cases on Part IVA strongly suggest the courts are prepared to interpret the existing provisions in a way that gives the provisions real teeth.

11.14 To the extent that any specific or general anti-avoidance provisions remain, they should all have the same “sole or dominant purpose” threshold. It would be impossible for taxpayers to have to operate in an environment where different anti-avoidance measures impose different purpose thresholds.

Problems with Part IVA

11.15 Business considers the existing provisions are being interpreted in a way that was not contemplated when these measures were first introduced. In particular, it seems clear after *Spotless* that the scope of the general anti-avoidance rules will not be limited by the courts to situations that may be described as “blatant, artificial or contrived”, but may apply to normal commercial arrangements where tax is but one of many factors. In our view that goes beyond the intention expressed by the present Prime Minister in his Second Reading Speech when introducing these provisions as Treasurer in 1981, and should be rectified.