Business Coalition for Tax Reform

Submission

to the

Review of Business Taxation

on

A Platform for Consultation

19 April 1999

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A. EXECUTIVE SUMMARY

The Review of Business Taxation (RBT) has given Australia a timely opportunity to enhance the international competitiveness of our business tax system. We face a rapidly evolving international economy full of fresh prospects and exciting directions. In taxation, as in other areas, Australia should seek to leap ahead of our competitors and ensure we are ready to take full advantage of emerging trends. To aim for anything less is to give up a critical chance to promote national prosperity for the benefit of all Australians.

We acknowledge the opportunity to meet these objectives is predicated on the successful implementation of the other elements of the comprehensive program of rebuilding our tax system outlined in *A New Tax System*. We support the broad thrust of that program and regard its passage as the most urgent task of the current reform program.

This submission on *A Platform for Consultation* (*Platform*) continues the Business Coalition's engagement with the consultative processes of the RBT. We welcome these processes as a means by which the business community and other stakeholders can offer the benefit of their experience and expertise. We urge a continuation of the consultative processes as reform proposals are further refined and as legislation is prepared to give effect to policy positions.

In view of the likelihood of a comprehensive package of business tax reform proposals and in view of the other extraordinary demands on the business community, the submission argues that a program of phased introduction of measures be worked through in full consultation with the business community.

Our submission urges the RBT to give full weight to the ongoing processes of tax design, drafting of legislation and administration in its recommendations to the government. The business community regards these features of reform as fundamental if the advantages of a recast business tax system are to be maintained and refined into the future.

The Business Coalition has almost forty members representing a diverse cross-section of Australia's business community. Inevitably this diversity gives rise to differences in priorities and in emphasis among members. While our basic approach is to build on areas of agreement, we also encourage the full expression of the differences of emphasis. We regard both of these as critical ingredients in the development of a solution on business tax.

In the eight weeks since the release of the 800 page *Platform* we have held wide-ranging discussions within our own membership and with a variety of tax professionals and expert advisors. In the course of this process we have seen a marked evolution of members' views. There is every reason to expect a continuation of this evolution of views over the coming months.

This submission presents the current state members' views. This embraces the areas of agreement as well as the differences of perspective. We

characterise the positions in the submission as "snapshots" to reflect the dynamic nature of our processes. Part D of this submission provides the most detailed treatment of positions while Part C contains a summary of the snapshots.

While support is far from unanimous, there appears to be a clear momentum in the direction of reducing the entity tax rate to 30 cents in the dollar. While reservations and opposition exist to some aspects of the possible reform agenda, there has been a notable narrowing of differences around key aspects of that agenda. This shifting of ground can be expected to continue as the implications both of specific measures and the broader impacts of the total reform package are integrated into business's assessments.

B. BACKGROUND TO THE SUBMISSION

The Business Coalition for Tax Reform (BCTR) welcomes the opportunity to provide comment to the Review of Business Taxation on the wide-ranging set of options for business tax reform canvassed in *A Platform for Consultation (Platform).*

Discussion of these options comes at a time when the globalisation of trade in both goods and services, of information flows and of investment is of increasing significance and when a more competitive tax system - of which business taxation is a key component - represents a critical step forward. A better business tax system is fundamental to the business community's ability to step up its contribution in generating higher standards of living and sustainable new job opportunities to the benefit of all Australians.

If business is to make the best contribution it can, the taxation and regulation environment in which business operates must be designed not merely in response to existing patterns but with an eye firmly on the emerging directions in which local and international pressures are steering our economic system.

In this context, the BCTR congratulates the government's judgement and strength in developing a comprehensive approach to the rebuilding of Australia's taxation arrangements.

The Need for Reform

The fundamental need for business tax reform arises because our existing arrangements fall well short of world's best practice. As indicated in the RBT's information paper *An International Perspective,* Australia ranks poorly in terms of perceptions of the competitiveness of our tax system overall and, in terms of most specific features of the business tax system, generally compares unfavourably with leading practice. The BCTR believes that we should aim at nothing less than to be at the forefront of international practice.

From the point of view of the business community, even on a purely domestic assessment there are major faults with our present business taxation arrangements. As was recognised in the Review of Business Taxation's earlier discussion paper *A Strong Foundation (Foundation),* these problems account for much of the existing complexity, uncertainty and instability evident in the existing system. Further they are a significant cause of a growing level of discontent on the part of the business community.

If the problems with the existing system are not addressed in a comprehensive way many of the worst features of the existing system will multiply. Thus, the appropriate benchmark against which we should assess the options put forward in *Platform* is not so much the existing set of business tax arrangements but the likely state of affairs inherent in the retention of the current system.

The most likely outcome of an absence of reform is a repeat of the experience of the recent past. We could expect more layers of anti-avoidance legislation, crackdowns on so called "concessional" arrangements, an increasing reliance on legislation by press release and a growing tendency to see long-standing rulings suddenly withdrawn.

In contrast, the business community needs simplicity, certainty and stability of tax arrangements if it is to take the investment decisions that will underpin improvements in international competitiveness and the creation of sustainable job opportunities.

The Business Coalition for Tax Reform

The Business Coalition for Tax Reform (BCTR) was formed in October 1997 to help inform the business community of the options for tax reform and to promote the case for rebuilding the Australian tax system. The BCTR is an expression of the business community's well-founded dissatisfaction with the existing tax system and the direction in which it has been headed over the past decade.

Since October 1997 the membership of the BCTR has grown to include almost 40 industry associations from all sectors of the economy representing small, medium and large business. Our membership is listed below:

Aluminium Council
Association of Consulting Engineers Australia
Association of Superannuation Funds of Australia
Australasian Railway Association
Australasian Soft Drink Association
Australian Bankers Association
Australian Business Chamber
Australian Chamber of Commerce and Industry
Australian Constructors Association
Australian Food and Grocery Council
Australian Hotels Association
Australian Industry Group
Australian Institute of Company Directors
Australian Institute of Petroleum
Australian Retailers Association
Australian Society of CPAs
Australian Stock Exchange
Business Council of Australia
Corporate Tax Association of Australia
Electricity Supply Association of Australia
Employers Federation of NSW
Federal Chamber of Automotive Industries
Institute of Chartered Accountants

Insurance Council of Australia
Investment and Financial Services Association
Master Builders Australia
Minerals Council of Australia
National Association of Forest Industries
National Farmers Federation
Property Council
Restaurant and Catering Australia
SA Employers Chamber of Commerce & Industry
State Chamber of Commerce NSW
Tasmanian Chamber of Commerce and Industry
Tourism Council of Australia
Urban Development Institute of Australia
Victorian Automobile Chamber of Commerce
Victorian Employers Chamber of Commerce and Industry
West Australian Chamber of Commerce and Industry

Clearly our membership is very diverse and this inevitably gives rise to differences in priorities and in emphasis among members. Accordingly, the BCTR has pursued reforms to the tax system on which there is a high level of agreement among our members. At the same time, we have not attempted to constrain individual members from advocating their own particular priorities. Through this approach we have harnessed the benefits of co-operation in the promotion of our overall approach while preserving the freedom of individual members to give full expression to their own priorities.

From the outset we agreed to take a comprehensive view of tax reform. Following a detailed process of consultation with a broad cross-section of the community and on the basis of a concerted research effort, we emphasised the need for reform of indirect taxes at both the Federal and the State/Territory levels; of personal income tax arrangements and their interactions with the social security system; of Federal/State financial arrangements as well as business taxation.

The BCTR supports the broad direction of reform outlined by the government in *A New Tax System* and acknowledges the changes put forward represent the most comprehensive proposal to remodel the tax system in over a generation.

We have also recognised the interrelationships between the different elements of reform and the importance of considering the individual components in the context of the overall changes to the entire set of tax arrangements.

The Ongoing Tax Reform Agenda

In all aspects of the tax system there will naturally remain further improvements to be made after the current round of reform measures is

implemented. We include in this the need to address the payroll tax question and the associated questions of further change to Federal/State relations, the tax treatment of long-term savings, the outstanding high effective tax rates associated with the interaction of the social security and income tax systems and the need to meet the inevitable tax challenges of the growth in electronic commerce.

As discussed below, there is a need for serious attention to be given to the ongoing development of the business tax system. Similarly, the BCTR argues that processes should be put in place to facilitate future progress in these other areas of taxation. The manner in which this could be achieved should be settled with the business community as well as with other stakeholders.

Business Tax Reform

From the first half of 1998 the BCTR argued for an independent review of business tax arrangements. Furthermore we maintained that the fundamental problems with both the design and administration of business taxation called for an ongoing co-operative effort on the part of both the taxation authorities and the business community. A little over a year ago the BCTR made the point that:

> "to have any chance of success, comprehensive reform of the business tax system would have to be consultative and would have to draw on the expertise of practitioners …. It would also have to be done at a pace that allowed proper digestion of proposals and their implications. To do otherwise would be self-defeating."[1]

Against this background the BCTR welcomed the Government's announcement of 14 August 1998 establishing the Review of Business Taxation (RBT) under the Chairmanship of Mr John Ralph AO. The BCTR also welcomed the subsequent appointment of Mr Rick Allert AM and Mr Bob Joss to the Review. The BCTR is committed to engage constructively with the Review's processes.

In developing our approach to business taxation the BCTR has maintained our overall objectives for reform.

> *BCTR Objectives for Tax Reform*
>
> "To enhance international competitiveness and fairness in taxation and to create a climate favourable for investment, job creation and saving."

In addition, we have conducted discussions over the broad principles we consider should form the basis of business taxation changes. The development of the BCTR business tax principles is ongoing and revolves around the six draft principles set out below.

[1] Fergus Ryan, Chairman of the Business Coalition for Tax Reform, "The Business Tax Reform Agenda", Corporate Tax Association Convention, Melbourne, 4 May 1998.

BCTR Draft Business Tax Principles

"1. The business tax system should be simple, transparent and minimise uncertainty.

"2. The tax system should not favour or disadvantage particular business structures over others.

"3. Taxation for the purpose of raising revenue should not favour particular industry sectors or firms over others. At the same time potential should be preserved for the use of taxation measures to assist in achieving particular industry and social objectives. Such objectives should be justified on the basis of transparent and rigorous criteria and on the condition that the tax system provides a suitable instrument for achieving the stated objectives.

"4. The tax system should avoid the double taxation of business income and provide relief for all business expenses.

"5. The tax system should not impede organisational restructuring.

"6. The business tax system should be internationally competitive and supportive of increased national savings."

A Strong Foundation

The BCTR welcomed the release of the first RBT discussion paper *A Strong Foundation (Foundation)* in November 1998. In particular the BCTR welcomed the emphasis on improving the processes of tax policy design, drafting of legislation and administration of taxation. Two of the more critical areas for the BCTR are worth restating here. They are:

- 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 enhance the design, implementation and administration of business taxation arrangements on an ongoing basis.

These two areas are interdependent. In the BCTR Submission on *Foundation*, the following comments were made:

"The Board should be responsible to report on the effectiveness of the business tax system, including:

- Adequacy of resources within the ATO
- Quality of consultation

- Quality of action following consultation.

"It is imperative that for the Board to have a genuinely beneficial impact on the level of community trust and confidence in the business tax system, it must be effective in influencing the consultative process.

"The BCTR submits that the establishment of a proper, independent Board is a fundamental aspect of the reform process which requires further consultation with stakeholders."

C. OVERVIEW

The business community's attitude to options for reform of the business tax system continues to evolve. Convinced of the need for an internationally competitive regime, and mindful of relevant international benchmarks of best practice, a convergence of position on many possible changes is occurring.

While reservations and opposition exist to some aspects of the possible reform agenda, there has been a notable narrowing of differences around key aspects of that agenda. This shifting of ground can be expected to continue as the implications of both specific measures and the broader impacts of the total reform package are integrated into business's assessments.

The BCTR Approach to Business Tax Reform

Both the diversity of members' views and the changing character of business's attitudes to reform - are critical to the interpretation of this submission.

A central and consistent feature of the BCTR's approach to tax reform has been to insist our deliberations are informed by principled arguments and expert opinion on the one hand and the particular interests and concerns of our members on the other.

In our discussions of tax reform measures there is always a creative tension between these two sets of forces. The expert opinion and the particular perspectives of members are in a state of continual interaction and evolution. Over the past year or so the position of members on a wide range of business tax issues has changed considerably. All indications are that this process has accelerated since the release less than eight weeks ago of the 800 page *Platform*. There is no reason to suspect attitudes have stopped evolving.

Accordingly, the submission attempts to capture the areas of agreement *and* the diversity of opinion of BCTR members and is essentially a *snapshot* in time of the state of the evolutionary development of the attitudes of BCTR members.

Clearly, therefore, the snapshot presented in this submission should not be taken as a final position. Rather we fully expect members' attitudes to continue to evolve.

General Issues

Before examining the snapshots of BCTR members' positions on particular policy areas, there is a range of general issues that lay the foundation for many of the more specific items considered later.

Revenue Assumptions

Discussion of the options in *Platform* has been conducted without a full knowledge of the revenue implications of the full range of measures. 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.

Chapter 39 of *Platform* provides estimates of some of the more important options. However even where estimates are provided there is an important qualification:

> "some costings need to be viewed as indicative. In some cases the costings rely on assumptions about the extent of the relevant tax base and behavioural responses to the change in the taxation treatment being examined. The revenue impact may need to be modified if further information becomes available during the consultation process."

While, as a part of the consultation process the RBT has been helpful in explaining the basis of the indicative revenue estimates, there is an understandable residual disquiet over 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.

One point made in the face of this disquiet is that experience shows that while there is considerable room for error in respect of any given number, there are always swings and roundabouts so that losses in some areas tend to be offset by gains in others.

While this defense provides some consolation when there is a large number of small costings to deal with, it is less comforting when there is a heavy reliance on a single costing. This explains why in the response to *Platform* the costing of the removal of accelerated depreciation has attracted considerable attention.

Of a possible reduction in the company tax rate of 6 percentage points, the removal of accelerated depreciation would account for over 4.5 percentage points. If other elements of the move to an effective life basis for capital write-off are taken into account, the contribution amounts to around 5 percentage points.

In assessing the impact of the possible lower entity tax rate financed largely from the removal of accelerated depreciation, individual businesses and industry associations have generally assumed that the relationship between the cost of reducing the entity tax rate and the removal of accelerated depreciation as indicated in *Platform* is sustained over time. 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.

Implementation of measures

As noted earlier, the present state of Australia's business tax system presents a compelling case for comprehensive business tax reform. Furthermore, this submission indicates the considerable strength of support on the part of the business community in favour of wide-ranging reform.

At the same time however it is critical to recognise the difficulties presented by the timetable for reform as it is currently envisaged (i.e. with measures to take effect from 1 July 2000). At is stands, over the coming fourteen months:

- the RBT will make its recommendations about a full range of business tax issues
- the Government will then decide on what it assesses as the appropriate course of action in each area
- exposure legislation will be prepared
- the business community will have an opportunity to examine and provide comment on draft legislation
- suitably amended legislation will be submitted to and debated in the Parliament
- new procedures and systems will be put in place to accommodate the new business tax arrangements.

Over the same time period the business community also has to prepare for the indirect tax reforms foreshadowed in *A New Tax System* and, in addition, is dealing with the "millenium bug" issue.

In view of this, the start-up date of 1 July 2000 date for all measures is not felt to be realistic (this is particularly the case for early balancing companies). It is certainly not felt to be compatible with the need for business to have an appropriate opportunity to consider and provide input into draft legislation and also to be given adequate time to prepare for changed arrangements.

The BCTR considers that process 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.

In short the BCTR:

- submits that the opportunities for fundamental reform are too great to be placed at risk from undue haste and that a program of

implementation - possibly over a couple of years - should be worked out in full consultation with the business community

- agrees wholeheartedly with the spirit of consultation and greater accountability expressed in *Foundation* and submits that the current generation of reforms should be the implemented in a way that accords fully with that spirit.

Tax Incentive Benchmark

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."

The national taxation objectives were:

- Optimising economic growth
- Ensuring equity
- Facilitating simplification

The BCTR and others submitted to the RBT that saving and international competitiveness should be included as objectives in their own right.

In addressing the tax incentive benchmark it is important to recognise that tax incentives are defined against a benchmark of an abstract "ideal" tax treatment. Presumably the ideal against which tax incentives would be measured in the future would embrace both the investment and the entity taxation benchmarks canvassed by the Review. Thus tax incentives would be defined as departures from the treatment that would apply under a comprehensive income tax regime and the full integration of entity and personal taxation.

Relative to these benchmarks tax incentives could be positive (i.e. they favour the taxpayer - such as the R&D tax incentive or accelerated depreciation) or negative (i.e. they favour the revenue - such as the double taxation of foreign source income or the asymmetrical treatment of losses). It would appear appropriate that whatever procedures are put in place to assess and monitor positive tax incentives should also apply to negative tax incentives.

Possible criteria for tax incentives

The BCTR's draft business tax principle 3 is a relevant starting point in discussing the criteria for tax incentives.

> Taxation for the purpose of raising revenue should not favour particular industry sectors or firms over others. At the same time potential should be preserved for the use of taxation measures to assist in achieving particular industry and social objectives. Such objectives should be justified on the basis of transparent and rigorous criteria and on the condition that the tax system provides a suitable instrument for achieving the stated objectives.

While this is useful it does not overcome the inherent difficulty in specifying the criteria for tax incentives that arises 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 the more "economic rationalist" justifications for the government to provide incentives. This narrower range of criteria could include:

- Tax measures to partially offset situations where the benchmark tax treatment itself creates a distortion (a clear example is to correct for the bias against saving inherent in the comprehensive income tax approach)

- Where there is a robust argument for a market failure (examples could include the immediate deductibility for certain capital expenditure on land care and the equity gap that can be experienced by small firms seeking to raise venture capital)

- Where there is a case to promote competitive neutrality (for example where government spending provides a selective benefit to one industry or region, tax incentives could be an effective means by which the treatment of other industries or regions could be brought into balance). Examples of this can be found in the private provision of infrastructure.

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.

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 to 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.

Arrangements to monitor or review tax incentives

An important additional dimension of the tax incentive benchmark concerns the arrangements to monitor or review the effectiveness of relevant provisions. 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

There is very strong support for maintaining the existing Research and Development Incentive and increasing it to maintain its real value in the face of any reduction in the entity tax rate.

There is empirical evidence that suggests 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 Productivity Commission and the Mortimer Report suggest that external benefits are generated by the tax concession.

Recent measures to refine the design of the incentive, including the narrowing of the definition of R&D, the more limited registration period and constraints on the deductibility of feedstock costs now ensure the incentive is both highly targeted and very likely to influence behaviour. These changes reinforce the need for a timely increase in assistance for the critical area of research and development.

Tax preference claw back

A central feature of the present system of company taxation is the washing out of tax preferences at the shareholder level. This occurs because the unfranked distributions made from income on which Australian tax has not been paid are taxed at the shareholder's marginal tax rate without relief. In effect there is double taxation as tax preferences, allowances for prior year losses and credits for foreign tax paid are clawed back on distribution. (In effect the claw back is a negative tax incentive.)

In *Platform* two arguments are put forward against addressing this problem. These are:

- the cost to revenue of allowing full flow through of tax incentives
- that "many incentives are currently perceived as meeting their objectives at the entity level" so the cost of flow through would generate "little apparent benefit".

There are two reasons that might support the second of these arguments:

- where the interests of managers and owners are sufficiently separate, tax incentives may influence investment decisions even though the owner stands to receive no substantial benefit in terms of the after-tax value of distributions

- an entity that can benefit from retaining tax preferred income can deliver the benefits of tax deferral to its shareholders.

While, on this logic, the claw back of tax preferences may be appropriate for larger entities, it is by no means apparent that the same is the case for closely held entities where the management and the ownership of the entity is unified. In cases where the entity structure is a close substitute for a partnership or sole trader, the effectiveness of tax preferences raises important issues of competitive neutrality.

There is therefore an argument for allowing a selective flow through of tax preferred income for some closely held entities. This is taken up again below in the section on the consistent treatment of entities. The criteria for such a selective flow through should be set in consultation with the business community.

Profit retention in closely held companies

Platform raises the possibility of measures to limit the degree to which certain entities could retain income (perhaps with a distinction between income of different origins).

Such an approach would introduce high levels of complexity associated with compliance and administrative burdens.

The BCTR, along with many others, has argued consistently for an alignment of the top personal tax rate and the company tax rate to avoid this sort of complexity.

Greater use of accounting principles for tax

Platform raises the possibility of further consultation over the greater use of accounting principles for tax purposes. While there appear to be considerable attractions with this approach, it is evident that neither the revenue nor taxpayers would be comfortable with an unqualified alignment of tax and accounting rules. Additional issues revolve around the imprecision of accounting rules and the possibility that tax considerations could tend to drive the development of these rules if tax and accounting principles were aligned.

Reversion to the classical system

The business community has developed a strong attachment to the imputation system and there does not appear to be much support for this suggestion unless rates of income tax were considerably lower than is

currently the case. Even then, to do so would still offend against the principle of full integration of entity and individual taxation.

Two separate revenue neutral trade-offs

Platform suggests the overall constraint of revenue neutrality 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.

Such an approach seems to overlook the essential interrelationships between the different parts of the income tax system. An approach that preserved the maximum degree of flexibility would appear more attractive than an approach that locked in unnecessary constraints.

Summary of Snapshots of BCTR Members' Positions on Specific Issues

In our discussions of *Platform* we have subdivided the wide range of issues into eight areas. Each of these eight areas is given more detailed consideration in the sections that follow and reference should be made to these sections for a fuller understanding of the diversity of members' views. For convenience this sub-section provides a summary of the range of views on each of the specific areas. As explained above, the business position on business tax reform options is evolving. This summary indicates, in broad terms, a snapshot view of the range of BCTR members' positions.

1. Reforms to Imputation

There is a very strong preference for a Resident Dividend Withholding Tax relative to the alternative of Deferred Company Tax.

2. Consistent Treatment of Entities

A. Though not unanimous, very firm support is emerging to move in the direction of the more uniform taxation of entities. At the same time BCTR members are very clear about three qualifications in particular:

i) there should be a carve out for collective investment vehicles with a flow through of tax preferences

ii) a facility should be available to small business for a flow through of tax preferences on a selective basis

iii) there should be appropriate measures to ensure the tax treatment of superannuation is not adversely impacted by the entity tax proposals.

B. There is considerable support for a profits first rule designed in a way that ensures genuine returns of capital are not adversely affected.

C. While there is also support for a broader definition of dividends, there is a strong feeling that it should be based around a list of specific inclusions.

3. Consolidation

While it is fair to say there is considerable wariness about the consolidation proposals discussed in *Platform*, support is emerging for the development through genuine consultation of a comprehensive optional consolidation regime built around the start made in *Platform*.

4. International Taxation

A. There is extremely strong support for the introduction of a concerted program of treaty re-negotiation.

B. There is equally strong support for improving the international competitiveness of the tax system by allowing streaming of offshore earnings directly to non-resident shareholders.

C. Strong support has also emerged for an extension of relief from double taxation of foreign source income by improving the creditability of foreign tax.

D. There is support for a tightening of thin capitalisation provisions on the understanding that appropriate transitional rules would prevent hardship in the case of pre-existing arrangements.

5. Wasting Assets, Goodwill and Trading Stock

A. Support for the acceptance as a general principle (while allowing for exceptions*)* of a regime under which wasting assets were treated on a basis more consistent with accounting principles has a number of elements. These include:

i) Very strong support for deductibility to be available to the bearer of the expenditure
ii) Equally strong support for the cost base to be the actual cost to the taxpayer
iii) With clear exceptions, there is support for having deductions start when assets are ready for use
iv) Emerging and qualified support for the spreading of depreciation deductions over the economic life of the asset
v) Support, again with some clear exceptions, for the removal of balancing charge rollover relief

vi) Very strong support for ensuring all legitimate business expenditure can be written off or immediately deducted.[2]

B. Again with some exceptions, there is support for treating acquired goodwill as a wasting asset.

C. There is strong support for taxpayers nominating a consistent treatment for the valuation of trading stock.

6. Taxation of Financial Arrangements, Leases and Rights

A. In respect of the treatment of financial arrangements, while there are a number of important specific concerns, there is very clear support for accepting the adoption of a timing adjustment approach where practical, allowing an elective mark-to-market approach and taxing other assets and liabilities on realisation.

B. In relation to leases:

i) there is broad support for the retention of the present arrangements

ii) there is strong support, however, for measures to prevent the assignment of lease tails.

C. In relation to rights, there is very strong support for an improved treatment of expenditure on rights.

7. Capital Gains Taxation

BCTR members expressed differing degrees of support for a range of options to reform the taxation of capital gains.

A. There is very clear support allowing rollover relief for scrip for scrip and similar transactions for a range of entities (and not limited to listed companies).

B. There is strong support for allowing carry-back of capital losses in respect of assets acquired after 1 July 2000.

C. There is very clear support for targetted capital gains relief to encourage the development of the venture capital market.

D. With clear exceptions, there is very firm support for a tightening of averaging provisions.

[2] This item interacts with the options for changing FBT arrangements with respect to entertainment. If entertainment were to be removed from the FBT regime, there may be a case to fully or partially exclude its deductibility.

E. There is very strong support for replacing the goodwill exemption for small business with a general exemption.[3]

F. Although there are clear exceptions, there is strong support for the further evaluation of proposals to restructure relief from capital gains tax at the individual level by replacing indexation with other arrangements.

8. Fringe Benefits Taxation

A. With clear exceptions, there is a strong measure of support for transferring the liability for fringe benefits tax to the employee.

B. There is very strong support for removing on-premises car parking from the FBT regime.

C. Although there are clear exceptions there is strong support for removing entertainment from the FBT regime and, in addition, reverting to non deductibility.

D. While not unanimous, there is strong support for bringing the valuation of car benefits more closely into line with market values.

The Entity Tax Rate and the Steps Ahead

While support is far from unanimous, there appears to be a clear momentum among BCTR members in the direction of reducing the company tax rate towards 30 cents in the dollar.

In terms of the tangible improvement to international competitiveness and because of the signal it would impart, the business community in general would like to see a lower corporate tax rate.[4] Clearly however, in the context of a revenue neutral business tax reform this could only be achieved through an expansion of the entity tax base.

It has been argued that business tax reform is, therefore, a zero-sum game and that a lower entity tax rate can only be financed with increases in the tax burden faced by particular sections of the business community. It is pointed out that this might imply a reduction in international competitiveness in particular areas.

[3] There is an assumption made in this support that there would be no lowering of the overall generosity of this relief.

[4] It is often acknowledged however that lowering the entity tax rate does create its own difficulties if it increases the gap between the top personal income tax rate and the entity tax rate.

This however is a static view that overlooks the critical contribution improved business tax arrangements can make:

- to the expansion of commercial activity
- to increases in the valuation of Australian businesses
- in reducing compliance cost burdens.

Each of these areas has the potential to significantly improve revenue collections.

Platform put forward an estimated growth dividend of $200 million in extra revenue from the business tax system by 2003-04. The basis of this growth dividend is the greater economic efficiency expected to arise from a closer alignment of commercial and tax values together with the reduction in the entity rate to 30 cents in the dollar. This is acknowledged to be a conservative estimate and it is anticipated that a larger dividend would be generated in the longer term.

The summary of BCTR members' positions outlined above contains several reform measures in addition to those taken into account in the RBT's estimate of the growth dividend, that could also be expected to contribute to a greater business tax base through expanded economic activity, improved valuation of domestic businesses and lower compliance costs. The BCTR is keen to explore with the RBT the potential revenue gains from the full range of reform options.

There is a strong view that we should be able to do better that a growth dividend of $200 million particularly in the medium term. At the same time it is acknowledged that, in a more immediate sense, if all the measures canvassed above were introduced, it is still unlikely the company tax rate could be lowered to 30 cents in the dollar by 2003-04.

This presents a new challenge for business. Having made good headway to date we clearly have further steps to take in continuing to explore the directions of reform and also in prioritising the options we have before us. In this context we need to weigh alternative options against the benefits of incremental reductions in the entity tax rate in the short term and against their impact on future revenue collections.

D. SPECIFIC POLICY AREAS

1. REFORMS TO IMPUTATION

Snapshot of BCTR Members' Positions

There is a very strong preference for a Resident Dividend Withholding Tax (RDWT) relative to the alternative of Deferred Company Tax (DCT).

Discussion

There is strong opposition to the deferred company tax option in the business community on the grounds that it would adversely impact on international competitiveness and would represent an additional charge on company profits. Relative to this option[5] there is support for a RDWT insofar as it would meet these two objections with the DCT. While the RDWT has support, the third alternative - the taxation of inter-entity distributions - should not be ruled out as a possibly attractive alternative.

It should be noted however, that relative to the existing system the RDWT could have damaging impacts on large sections of the business community unless modifications and exclusions were introduced.

Critical Issues

Business opposition to DCT

Particular concerns with the proposed DCT system include:

- the fact that DCT is a charge against company profits which could be expected to reduce earnings per share and the valuation of companies, thus increasing the cost of raising capital
- 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
- DCT could be unlikely to give rise to a credit for foreign taxes to foreign investors.

These concerns are seen to outweigh the benefits of greater simplicity held out as the key argument in favour of a DCT.

[5] In discussions of these options the comment has been made that, aside from the bring-forward of tax collections on unfranked distributions (and in the case of the DCT the greater tax burden on non-resident shareholders), all three options are measures that appear to duplicate the intentions of the additional reporting and withholding requirements that business has been required to put in place in recent times (i.e. shareholder's tax file numbers and, more recently, identification of the ultimate beneficiary of trust distributions).

As discussed below in the context of international taxation, the proposal to switch DCT for dividend withholding tax and options to permit the streaming of offshore profits to non-resident shareholders both have definite attractions. However, to date neither of these has been linked sufficiently to the DCT alternative to give reason to think that they would not be equally viable and attractive in the context of the RDWT (or other options for that matter).

Support for resident dividend withholding tax (RDWT)

There is general support for RDWT relative to the DCT alternative as it does not entail as harsh an impact on corporate profits and international competitiveness as the DCT. At the same time, RDWT would ensure that all distributions through the entity chain are subject to full corporate tax and that distributions to individuals are taxed at source, thus satisfying the government's integrity concerns. However, complex dividend streaming rules dealing with situations, for example where franked dividends were paid to some shareholders and unfranked dividends to others would have to be addressed in ways other than through the structural reform offered by the DCT.

The RDWT would however reduce the income of entities currently in receipt of unfranked distributions. Unless addressed this could adversely impact the valuation of listed companies and result in a loss of international competitiveness in a range of circumstances. Incorporated joint ventures, in particular, may suffer an erosion of competitive position.

Taxation of unfranked inter-entity distributions

Whilst this option essentially achieves the same outcome as the first two options for inter-entity distributions, unfranked dividends paid to individual shareholders are not taxed at source but rather in the recipient's hands. While the RBT appears unlikely to accept this alternative due to integrity concerns - i.e. the potential that unfranked dividends will not be declared as income, there is a strong case for keeping the option open in view of the possible complexity that may arise as the RDWT is considered more closely. Again, complex dividend streaming rules would potentially remain with this option, however there would be some reduction in compliance with no need to pay DCT or deduct RDWT on unfranked dividends.

Other issues

Adjustments for non-resident investors

Under the options to reform imputation, non-resident investors 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 similarly refunded and withholding tax applied to the dividend (plus the refund) thus putting the non-resident investor into the same tax position as under the current regime.

Double taxation of tax preferred income

The potential for double taxation arising through tax preferences is also addressed. While four options for overcoming such double taxation are detailed, *Platform* maintains that double taxation is not common. In brief, the four options are:

- refunding franking account surpluses on liquidation to the extent that the surplus relates to temporary tax differences
- allow “double tax” payments to be offset against company tax liabilities
- allow prepayments of tax on temporary tax preferences
- adjust the cost base of the funding asset for distributions from unrealised gains.

Of these alternatives, the option to allow prepayments of tax in respect of temporary tax preferences would appear to be the best.

2. CONSISTENT TREATMENT OF ENTITIES

Snapshot of BCTR Members' Positions

A. Though not unanimous, very firm support is emerging to move in the direction of the more uniform taxation of entities. At the same time BCTR members are very clear about three qualifications in particular:

   i) there should be a carve out for collective investment vehicles with a flow through of tax preferences

   ii) a facility should be available to small business for a flow through of tax preferences on a selective basis

   iii) there should be appropriate measures to ensure the tax treatment of superannuation is not adversely impacted by the entity tax proposals.

B. There is considerable support for a profits first rule designed in a way that ensures genuine returns of capital are not adversely affected.

C. While there is also support for a broader definition of dividends, there is a strong feeling that it should be based around a list of specific inclusions.

A. Treatment of Trusts as Companies

The stated rationale for a more consistent treatment of entities is that:

- investments should not be taxed differently whether they are housed within a trust as opposed to a company

- that business tax arrangements should avoid taxing different types of entities differently.

While this argument clearly has merit, the approach taken in *Platform* would hardly do away with inconsistent treatment of investments as business, operating outside the entity framework (i.e. as direct investors, sole traders and partners) will be taxed differently to investors in entities.[6] This fundamental difficulty with the approach proposed by the RBT lies at the heart of the qualifications to the consistent treatment of entities approach.

The same difficulty is also the key to understanding the dispersion of views in the business community on the issue. Under present arrangements trusts

[6] Viewed from this perspective, the approach taken in the *Platform* to the consistent treatment of entities represents a further departure from the entity taxation benchmark put forward by the Review of Business Taxation that entities should be considered as extensions of their ultimate owners. This is recognised in *Platform* but the obvious alternative - taxing companies as trusts - is ruled out on the grounds that it is inconsistent with the terms of reference of the Review given the combination of the constraint of revenue neutrality and the aim of moving in the direction of a lower entity tax rate.

correct for a fundamental problem with the taxation of companies relative to the ideal of full integration. From this perspective, the proposal to tax trusts as companies will make matters worse rather than improving them.

i) *Collective Investment Vehicles (CIVs)*

CIVs are essentially close substitutes for direct investment. From the point of view of neutrality, income earned by (and tax preferences available to) such vehicles should be taxed in the hands of individual investors as if the investment were undertaken directly. This would ensure there are no adverse cash flow effects on people receiving distributions of assessable income from vehicles such as cash management trusts and that such investors also had access to tax preferences. For consistency this rule should also apply to other widely held vehicles that distribute their income annually such as bond trusts, common funds, managed funds and property trusts.

ii) Selective flow-through of tax preferences to other entities

As has been explored in Part B, there is a strong case for allowing some selective flow through of tax preferences to other entities - particularly where there is a high degree of substitutability between conducting business as a sole trader or partnership and conducting business through an entity. The criteria for eligibility for the selective flow-through of tax preferences should be subject to consultation with the business community.

iii) Superannuation

The Australian tax system grants particular tax treatment to superannuation, partly in recognition of the tax-created bias against saving inherent in an income tax approach. Consistent both with the national importance of private saving and the fact that the Review of Business Taxation has not considered superannuation in a comprehensive context, the BCTR benchmark recognises that the proposals to tax entities more consistently should ensure that the tax treatment of superannuation is not adversely affected.

B. The Profits-First Rule

Under current tax rules it is possible to choose the source from which share buy-back and cancellations are made. Under the changes proposed in *Platform*, where there is a termination of an equity holder's interest, a “slice” approach would apply under which the distribution will be deemed to come from contributed capital, taxed profits and the balance from untaxed profits, based on the calculated contributed capital and tax-paid franking credit balance per share. The slice approach appears to be inconsistent with a profits-first rule which taxes normal distributions in full as dividends whereas the slice approach does not treat termination of interest situations as entirely capital.

Consequently, modifications to the profits-first rule and slice approach should be adopted to ensure appropriate tax treatment in the case of a genuine return of capital.

C. Definition of a Dividend

In *Platform*, the definition of a dividend is proposed to be broadened under one of three options to include such things as goods and services provided to shareholders at a discount, debt forgivenesses and non-commercial loans.

The extended definition would apply even where benefits are provided to associates. Dividends would continue to be limited to profits.

The proposed definitions appear overly broad and adopt an 'all-in' approach with limited exclusions. A better approach would be to define items which are to be specifically included in the amending legislation.

For public companies, a $1,000 per annum threshold for each shareholder is proposed in respect of discounted goods or services provided. For example where a 5% discount on sales was offered, a shareholder would need to spend $20,000 with the company before the threshold was exceeded. In most cases such a threshold is unlikely to be exceeded and therefore it is suggested that such discounts be excluded from the definition rather than subjecting public companies to what would be a very heavy compliance burden in monitoring the situation.

Other Issues

Transitional arrangements for trusts

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.

However, uncertainty remains concerning the ability of trusts taxed as companies to restructure and distribute such amounts tax-free to beneficiaries once the profits-first rule described above is overlaid.

Broad transition rules will need to apply to avoid harsh outcomes during any transition. These should be worked through in close consultation with the business community. Consideration should be given to granting relief from liabilities for capital gains tax and stamp duties arising from any significant changes to the tax treatment of business structures.

3. CONSOLIDATION

Snapshot of BCTR Members' Positions

While it is fair to say there is considerable wariness about the consolidation proposals discussed in *Platform*, support is emerging for the development through genuine consultation of a comprehensive optional consolidation regime built around the start made in *Platform.*

Discussion

The BCTR appreciates the potential benefits from the options to tax groups of entities on a consolidated basis. These benefits include the transfer of franking credits, the freeing up of loss transfers, simplified intra-group dividend flows, and fewer tax barriers to reorganisation. While reduced compliance costs and a simplified tax system are often linked with consolidation proposals, it is not clear either from international experience or from the issues raised in *A Platform for Consultation*, that this is really the case.

There is widespread agreement that, if adopted in their present form, the proposals in *A Platform for Consultation* would impose severe constraints, additional complexity and a less competitive outcome for many groups. The extent of these negatives suggests that the present proposals can not be regarded as representing an overall improvement to present arrangements.

Nevertheless, a strong case can be made to suggest that there are benefits to consolidation that can be attained if a number of improvements are made to the existing proposals. The benefits of consolidation are all the more attractive bearing in mind the likelihood that further anti-avoidance measures to counter loss duplication and value shifting will probably be considered necessary in the absence of the consolidation approach.

In the area of consolidation, perhaps even more than others, it is clear that considerable refinement of proposals through continued consultation is needed if we are to achieve the best policy outcome.

Critical Improvements to the Consolidation Proposals

The need for a resident Australian holding company

The proposed consolidation regime would only be available to foreign-owned Australian entities held by a common Australian resident parent. Some existing groups will not be able to achieve this structure without incurring prohibitive tax costs in other jurisdictions. If, as proposed in *Platform,* existing provisions permitting tracing through offshore entities were to be removed, the effective Australian tax rate of many groups would rise.

It is understood there are concerns about the ATO being able to satisfy itself about the 100% ownership continuing unbroken up the chain. There are also integrity concerns on exit that would not arise with an Australian resident parent. Ways of resolving these issues without forcing groups to incur significant restructuring costs should be explored. One alternative would be to allow grouping and CGT rollover to continue groups formally consolidated for tax purposes.

Forfeiture of tax losses on entry

The BCTR is mindful that concerns about loss cascading and duplication would lead to a preference for a consolidation model where pre-entry losses are forfeited on entry into the consolidated group (Option 1 on page 561). This would, however, represent a radical departure from the existing regime, which permits the carry-forward of pre-entry losses, subject to the same business test. Removal of the same business test because of concerns about loss duplication would compound an already highly punative treatment of losses in order to address the comparatively minor problem of loss duplication. It would also infringe Principle 4 on page 558 of *Platform* that losses and franking account balances should be able to be brought into a consolidated group.

Of the options listed on pages 561-4 in *Platform*, Option 5 (quarantining losses within the group) or Option 6 (leaving loss entities outside the group until the losses were recouped) would appear to offer the best solution.

An alternative of limiting the losses brought into the group to the consideration paid for the shares would have the benefit of simplicity and would appear to meet integrity concerns. This approach would be a more attractive starting point than the options listed in *Platform.*

Inter-company dividends

The multiple taxation of dividends flowing between companies is currently addressed through a rebate system. The rebate system works only because companies within a corporate group are treated as separate legal entities, a distinction that would be done away with under the consolidation proposals. Where a consolidated group is in an overall tax loss position, dividends received from outside the group would have to be offset against those losses, with the result that the losses would be "wasted". A number of corporate groups would suffer significant financial loss if this issue is not adequately addressed. The BCTR is attracted to one of the two possible solutions that have been put to the Review of Business Taxation – a dividend deduction or a modified exemption system.

Additional foreign tax

Under the consolidation proposals, the Australian holding company would be regarded as being liable for the group's tax. This could result in additional "top-up" tax on other subsidiaries at home under the CFC rules of some other countries (including the US). While this is a shortcoming in the CFC regimes

of those countries, to avoid a loss of competitiveness foreign-owned groups that are adversely affected should be able to opt out of consolidation and group losses and use CGT rollover relief outside of the consolidation regime.

Value shifting

Proposals to address value shifting outside consolidated groups would be improved through use of a 50% associate-inclusive control test below which the value shifting measures did not apply.

In general, measures should be designed to ensure that no unreasonable compliance burden is imposed by a requirement that companies demonstrate that normal commercial transactions do not result in a value shift.

Other Issues

- The proposal that all group entities be jointly and severally liable for the group's tax liabilities should end on exit. Otherwise tax considerations might force companies to sell assets when it would make more sense commercially to sell shares.

- The characterisation of income and expenditure could be different under a consolidation regime as compared to a separate entity basis. This will need to be managed to ensure unintended consequences are avoided.

- The RBT has confirmed in discussions that the consolidation regime is not intended to lead to the allocation and possible quarantining of expenditure, particularly interest. The legislation will need to specifically address this point.

- Groups would prefer to be able to choose between aggregating individual entity tax returns and using modified equity accounts.

- Consideration should be given to reducing the threshold for consolidation to less than 100%, as in the case of a number of comparable countries.

- Rollover relief should be extended to entities that are CFC's of Australian groups.

4. INTERNATIONAL

Snapshot of BCTR Members' Positions

A. There is extremely strong support for the introduction of a concerted program of treaty re-negotiation.

B. There is equally strong support for improving the international competitiveness of the tax system by allowing streaming of offshore earnings directly to non-resident shareholders.

C. Strong support has also emerged for an extension of relief from double taxation of foreign source income by improving the creditability of foreign tax.

D. There is support for a tightening of thin capitalisation provisions on the understanding that appropriate transitional rules would prevent hardship in the case of pre-existing arrangements.

Discussion

A central need for tax reform in Australia is to improve international competitiveness and the international dimension of our tax system is of critical importance if Australia is to compete effectively for foreign investment and as a base for offshore investors. The BCTR sees international competitiveness as central to our ability to enhance our standards of living and to sustain higher rates of job creation.

The high priority the BCTR attaches to improving our international competitiveness has led us to go beyond the proposals in *Platform* for reform of international taxation. We emphasise two critical issues of particular significance for Australian based multinationals – the urgent need to re-negotiate tax treaties with our major trading partners, and the improved treatment of foreign source income.

Critical Issues

A. Treaty re-negotiation

A definite program of determined treaty re-negotiation should be put in place. For instance, most other countries enjoy much more favourable treaty rates with the US than the 15% dividend withholding tax rate that applies to Australian-based multinational corporations.

B. Streaming

A major improvement to international competitiveness could be achieved by the removal of anti-dividend streaming rules that prevent effective streaming of profits earned offshore to foreign investors and waste imputation credits on

foreign shareholders who cannot use them. There would be a large revenue cost associated with the consequential greater level of franked dividends paid to domestic investors.

In the absence of some dividend streaming rules, expanding the conduit rules by moving to a foreign income account method would attract support.

C. Greater creditability for foreign taxes

The proposal to allow franking credits for withholding taxes paid on foreign dividends flowing through to residents is supported, as is the proposal to allow franking credits to flow through to Australian investors in a non-resident company. The BCTR recommends further options be considered to improve the creditability of foreign tax.

D. Thin capitalisation proposals for inbound investment

Inbound investment

The current thin capitalisation rules (which limit interest deductibility where inbound investment is geared to excessive levels) do not take unrelated party debt into account. This has always limited their effectiveness. *Platform* proposes to move to a total-debt approach, using either worldwide group gearing or a fixed ratio. The proposal, while supported in principle, would need to be fleshed out in greater detail before a full evaluation of its impact could be made. Clearly, applying a new regime to existing investments financed on the basis of the current rules would amount to retrospective taxation so that suitable transitional arrangements would need to feature in any detailed proposals.

Interest deductibility for Australian-based multinationals

Platform proposes to limit interest deductibility where Australian entities are more highly geared than their controlled offshore associates. However, the Australian 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 local investors. Because these proposals would increase the cost of expanding offshore, they should only apply where gearing levels are significantly misaligned over the long term, and any adjustment should involve a deferral rather than the outright denial of deductibility.

Other Issues

- There is support for the proposal to tax capital gains realised by non-residents on the indirect disposal of certain Australian assets (through the use of interposed companies). However, a clear “substantial proportion” rule would need to be developed, and deemed disposals should not be taken to occur as a result of offshore mergers.

- While the current source rules work well, some changes are necessary to better match source under Australian law with the country imposing foreign tax. Mismatches in source currently result in the loss of foreign tax credits.

- The proposed entity tax/withholding tax switch is supported, regardless of the nature of the reforms to imputation. Such a switch would improve the ability of foreign investors to obtain foreign tax credits for at least part of Australian taxes paid.

- If a RDWT is adopted as an alternative to deferred company tax, 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.

- If the carve out for Collective Investment Vehicles is not adopted an alternative Non-Resident Investment Fund carve-out would preserve the current tax treatment of non-resident investors in Australian funds.

- The rules governing the taxation of Controlled Foreign Companies need substantial revision to reduce unnecessary complexity and avoid inequitable outcomes.

- The formal coding of transfer pricing methodologies is not considered necessary. Franking credits should not be denied where transfer-pricing adjustments are made.

- The adoption of US-style documentation requirements for transfer pricing is not supported – the Australian requirements are onerous enough.

5. WASTING ASSETS, GOODWILL AND TRADING STOCK

Snapshot of BCTR Members' Positions

A. Support for the acceptance as a general principle (while allowing for exceptions*)* of a regime under which wasting assets were treated on a basis more consistent with accounting principles has a number of elements. These include:

   i) Very strong support for deductibility to be available to the bearer of the expenditure
   ii) Equally strong support for the cost base to be the actual cost to the taxpayer
   iii) With clear exceptions, there is support for having deductions start when assets are ready for use
   iv) Emerging and qualified support for the spreading of depreciation deductions over the economic life of the asset
   v) Support, again with some clear exceptions, for the removal of balancing charge rollover relief
   vi) Very strong support for ensuring all legitimate business expenditure can be written off or immediately deducted.

B. Again with some exceptions, there is support for treating acquired goodwill as a wasting asset.

C. There is strong support for taxpayers nominating a consistent treatment for the valuation of trading stock.

Critical Issues

A. Wasting assets treated on basis consistent with accounting principles

i) Deductibility to be available to the bearer of the expenditure

The bearer of the economic loss (or who incurs the expenditure) should have entitlement to the deduction. This would avoid the current problems under which the deduction is available to legal owners only.

ii) The cost base to be the actual cost to the taxpayer

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 too arbitrary and too dependent on estimates and projections. If it

was to be adopted then it would provide too much uncertainty and be subject to disputation.

iii) Deductions to start when assets are ready for use

As a matter of principle there is support for the commencement of write-off when items are "installed ready for use or held in reserve." At the same time, scope should be reserved for particular treatment in specific circumstances such as very long lead-time projects.

iv) Accelerated Depreciation

A core option in the reform program is to remove accelerated depreciation to help finance a lowering of the entity tax rate. The lower rate would clearly have favourable benefits in terms of international competitiveness for industries that do not benefit greatly from the accelerated depreciation regime. It should be noted however that international competitiveness in all industries rests on effective tax rates rather than merely the headline rate. In addition, to the extent to which there is a degree of distortion under existing arrangements, the removal of accelerated depreciation could be expected to favour labour and knowledge intensive activity over capital intensive industries.

Consistent with the comments made in Part B above on the tax incentive benchmark, should accelerated depreciation be removed, the BCTR would support leaving open the possibility to grant accelerated write-off for some activities.

If accelerated depreciation were removed, suitable grandfathering should be provided.

v) Balancing charge offset rollover relief to be removed

While the removal of the balancing charge rollover arrangements would be consistent with the general approach on wasting assets, the extra revenue that could be expected from this would tend to diminish fairly rapidly if accelerated depreciation was removed. If the balancing charge rollover arrangements were removed, suitable grandfathering should be introduced.

vi) All legitimate business expenditure to be written off or immediately deducted

The proposal to eliminate blackholes is welcomed by business. It will be important that the method implemented to achieve this is correct. To this end it is important 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 deduction is available. Any listing via regulation should only be implemented to indicate desired write-off arrangements for specific cases. The proposal of listing blackhole expenditure risks a replication of the existing problems.

Other Issues

- The definition of a wasting asset needs to be clarified and should incorporate discussion on buildings and the ability to incorporate them within the regime.

- Taxpayers should have the option of either adopting published rates (following the proposed review by the ATO) 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.

- It is clearly important in the current environment that the revision of write-off rates proposed by the ATO proceed promptly with the benefit of business input. In the future, there should be a defined process for on-going consultation with business on keeping the schedules up to date.

- The proposed capping at $10,000 of the aggregate of immediate write-offs under the "less than $300" rule would be a very poorly designed measure to address a specific set of avoidance concerns.[7] The solution may be to introduce a pooling system whereby minor items above a certain threshold amount could be pooled and be depreciated over a certain period.

B. Goodwill

From the perspective of wanting to ensure Australian taxpayers maintain international competitiveness, it would be appropriate to have a regime that provides for the write-off of acquired goodwill. This treatment is available to many of our foreign competitors. It would also help arrest a 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 matter and further work will be necessary.

C. Trading Stock

Basis for valuation of trading stock

There is a very strong argument for the valuation of trading stock on a consistent basis with taxpayers allowed to select the basis of valuation for all their stock. This basis would best be met by Option 3[8] which allows taxpayers to select one of the current options for all stock and only allow a change in the method selected if the taxpayer could make a sound case based on non-tax considerations.

[7] 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. Likewise the scenarios highlighted by the RBT team at focus group meetings of a taxpayer with a significant number of small value items would best be addressed by applying a test of materiality rather than having a capped amount which is clearly biased against larger taxpayers.

[8] *A Platform for Consultation*, Discussion Paper 2, Volume 1, page 129.

Standing crops

Currently expenditure on planting and tending crops for sale or use in business is immediately deductible for tax purposes. However, there is no requirement to bring their value to tax until either severed or sold with the land. *Platform* contends that this arrangement provides significant tax deferral benefits for investors in long-life crops that are not available to other investors. It is therefore proposed that deductions be deferred until the value of the final crop is realised.

While this would appear to be in line with the general approach of moving to an effective life basis of depreciation, particular industries - such as timber plantations - would face a marked change in tax treatment. Given the broader benefits from such activities this area may provide grounds for specific departures from an effective life benchmark.

Overburden Removal

Decisions on overburden removal in the mining industry are driven by operational requirements. Currently overburden stripping is immediately deductible for tax purposes as a production operating expense and it is argued that this tax treatment accords with the economics of open pit and strip mining.

6. TAXATION OF FINANCIAL ARRANGEMENTS, LEASES AND RIGHTS

Snapshot of BCTR Members' Positions

A. In respect of the treatment of financial arrangements, while there are a number of important specific concerns, there is very clear support for accepting the adoption of a timing adjustment approach where practical, allowing an elective mark-to-market approach and taxing other assets and liabilities on realisation.

B. In relation to leases:

   i) there is broad support for the retention of the present arrangements
   ii) there is strong support, however, for measures to prevent the assignment of lease tails.

C. In relation to rights, there is very strong support for an improved treatment of expenditure on rights.

Critical Issues

A. Taxation of Financial Arrangements

- It is considered necessary for appropriate hedging rules to be introduced. On the basis that assets and liabilities are used to assist in managing risks, it is necessary for hedge transactions to be taxed consistently with the matching of the timing and classification (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 purchase expenditures.

- The hedging rules also need to allow for hedging strategies whereby a rolling series of hedge transactions are used to hedge a longer-dated exposure. Such strategies may be commercially necessary due to the absence or illiquidity of long-dated commodity hedge markets.

- It is considered that the safeguards listed in Option 1[9] (transaction basis*)* are too onerous and will impair taxpayers' ability to utilise this approach when electing a mark-to-market approach.

- A definition of realisation incorporated in the hedging rules is critical and should be based on economic substance rather than legal principles. For example, rollovers of hedges that relate to an underlying asset may be a

[9] *A Platform for Consultation,* Discussion Paper 2, Volume 1, page 169.

legal realisation but not an economic realisation that occurs on the disposal of the asset and the termination of the hedge.

- The RBT proposes the quarantining of losses for those 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 excise losses on such instruments from the general calculation of taxable income of business operations is contrary to the underlying philosophy of RBT on tax neutrality.

- Anti-avoidance provisions could be used to address any concerns on soft currency exploitation. 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. It must be reinforced that there are valid commercial reasons why certain taxpayers must enter into transactions in so called “soft” currencies - for example, a borrowing in that currency might be undertaken to hedge underlying assets held.

- Clear rules need to be introduced separating debt and equity. As proposed in the TOFA Issues Paper (released December 1996) a “facts and circumstances” test should provide certainty. It is important that the 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.

Transitional Issues

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

B. & C. Leases and Rights

- 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 there would be little difference between the tax-preferred approach and the sale and loan approach.

- While there is respect for the principles behind the approach discussed in *Platform*, there is widespread concern that the proposals will adversely impact upon small and medium business. In this context we note the relatively small anticipated gain to the revenue from the sale and loan approach.

- We note also that the splitting of depreciation claims between the lessee and the lessor would result in an extremely complex regime and increase the compliance burden on taxpayers as it is also assumed that the leased payments will need to be allocated in some manner into a taxable and non-taxable component.

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

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

- In relation to the taxation of rights, there should be a symmetry of treatment over the declaration of income in respect of a right and the deductibility of expenditure relating to the same right. The measures proposed in *Platform* are, however, very complex.

Transitional Issues

Any existing lease arrangement should be allowed to run its term as should fixed term contracts.

7. TAXATION OF CAPITAL GAINS

Snapshot of BCTR Members' Positions

BCTR members expressed differing degrees of support for a range of options to reform the taxation of capital gains.

A. There is very clear support for allowing rollover relief for scrip for scrip and similar transactions for a range of entities (and not limited to listed companies).

B. There is strong support for allowing carry-back of capital losses in respect of assets acquired after 1 July 2000.

C. There is very clear support for targetted capital gains relief to encourage the development of the venture capital market.

D. With clear exceptions, there is very firm support for a tightening of averaging provisions.

E. There is very strong support for replacing the goodwill exemption for small business with a general exemption.

F. Although there are clear exceptions, there is strong support for the further evaluation of proposals to restructure relief from capital gains tax at the individual level by replacing indexation with other arrangements.

Discussion

Discussion of the area of capital gains taxation has been surrounded by a number of complexities.

- There is a strong recognition of the potential importance of an internationally competitive capital gains tax regime. The extent and timing of the stimulation to economic growth and tax revenue is, however, very difficult to quantify.[10]

- The equity dimension of reform to capital gains taxation, in particular, is difficult to assess in the context of the scope for dynamic benefits from meaningful capital gains tax reform.

- There is an acknowledgement of the argument presented in *Platform* about the possible revenue leakage should effective rates of tax on capital

[10] In particular the issue of scrip for scrip rollover relief has attracted firm support as a means to remove a significant obstacle to efficient reorganisation. As indicated by the ACCESS Economics study undertaken for the Securities Institute, in a relatively short time the annual gain to revenue from a higher level of activity can be expected to outweigh the annual revenue foregone.

gains be noticeably different from the effective rates of tax on other forms of income.

- At the same time, however, it has also been pointed out that if lower headline rates on capital gains tax are financed with the removal of indexation, there would be no overall increase in the gap in effective rates of tax on capital gains and other income.

- This points to another area of difficulty - modeling the impacts for different taxpayers of the trade-off of indexation for other forms of capital gains tax relief at the individual level.

- Further, there is a perception that the behavioural impacts of a lower headline rate of capital gains tax would be more pronounced than equivalent relief provided though indexation.

For these reasons we have included in the BCTR benchmark the option to further evaluate proposals to exchange indexation for other individual capital gains tax relief measures.

Specific Issues

A. Scrip for scrip rollover relief

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 takeover 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 the efficiencies which come with economies of scale.

While it would seem that extension of scrip for scrip relief beyond listed companies is not favoured by the RBT because of potential avoidance situations, an approach such as adopted by the US would appear to offer protection against these problems.

Beyond scrip for scrip rollovers, consideration could be given to similar transactions such as deconsolidations, where a company is split into various businesses which are owned by the same shareholders prior to the split up.

B. Capital loss quarantining

Platform proposed 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 two to three year carry-back arrangement for assets acquired after 1 July 2000 would appear to be the best available alternative.

C. Targetted concessions for certain types of investment

There is a strong argument for keeping open the possibility for targetted concessions for particular industries including venture capital and high technology companies that are penalised in an internationally comparative sense by Australia's treatment of capital gains.

Further, it is argued there is a market failure manifested in the "equity finance gap" confronted by relatively small investors. It is pointed out that these small businesses can be a major source of innovation.

D. Tightening of Averaging Provisions

Tightening of the averaging provisions can be argued on the basis that current arrangements present an inappropriate opportunity for exploitation. However, it is important that a degree of averaging remain to meet the initial concerns relating to the bunching of gains that gave rise to the averaging provisions.

E. Replacement of the goodwill exemption for small business with a general exemption

There is a proposal to replace the current goodwill exemption for small business with an exemption of a suitable proportion of all capital gains on the disposal of active assets of a small business (defined as those with net assets of less than $5m). This measure would seem appropriate for simplicity and consistency reasons but would require further clarification of the suitable level of the changed arrangements.

8. FRINGE BENEFITS TAX

Snapshot of BCTR Members' Positions

A. With clear exceptions there is a strong measure of support for transferring the liability for fringe benefits tax to the employee.

B. There is very strong support for removing on-premises car parking from the FBT regime.

C. Although there are clear exceptions these is strong support for removing entertainment from the FBT regime and, in addition, reverting to non deductibility.

D. While not unanimous, there is strong support for bringing the valuation of car benefits more closely into line with market values.

Discussion

A. Liability for FBT

A return to the liability falling with an employee would remove the inequity of an overpayment of tax from the high FBT rate compared to individuals' marginal rates and would remove the perception of inequity associated with employer liability for tax on employee benefits. At the same time two arguments putting the contrary view are also encountered. These relate to the human resource issues a switch in the liability for tax would give rise to and the extra compliance burden associated with attributing pooled benefits to individual employees.

B. Car Parking

Removing car parking provided on premises would significantly reduce compliance costs at comparatively little cost to the revenue.

C. Entertainment

The reversion of entertainment to a regime where it is not subject to FBT and not deductible does attract support relative to the present system with its very high compliance costs. It is certainly a move in the right direction given that much entertainment expenditure is a legitimate business expense.[11]

D. Car benefits

There is a strong case in principle for the valuation of car fringe benefits to be brought closer to commercial values. This is not a unanimous view.

[11] A further step to improve the tax treatment of entertainment expenses would be to make it fully or partially deductible (as is the case in many other jurisdictions).

Other Issues

- The opportunity could be taken to introduce a 'remuneration test' into the FBT legislation to improve equity and to address a fundamental problem of FBT in that it goes beyond the original intention of the legislation to tax remuneration.

- The FBT Reporting Bill could also be revisited to address provisions that impose complex and costly compliance requirements for little benefit.