AUSTRALIAN **B**ANKERS' **A**SSOCIATION **I**NC.

Tony Burke
Director

Level 3, 56 Pitt Street
Sydney NSW 2000
Telephone: (02) 8298 0409
Facsimile: (02) 8298 0402

1 May 2009

AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

Dear AFTS Secretariat,

Australia's future tax system

Submission on December 2008 Consultation Paper

The Australian Bankers' Association (**ABA**), Australia's peak banking industry body, is pleased to make this further submission to the Australia's Future Tax System Review (**Review**).

The Attachment to this letter sets out the ABA's comments on certain aspects of the Australia's Future Tax System Consultation Paper (**Consultation Paper**) that was released by the Review in December 2008.

In summary, the ABA considers that there should be no large-scale changes in the way that Australia levies tax, particularly with respect to businesses. Rather, as a mid-level economic power, Australia should determine its general direction for tax changes based on international consensus as reflected in country practice and international agreements, while ensuring that Australia remains an attractive destination for inbound investment and a significant base for outbound investment.

Similarly, in keeping with current international trends, Australia should gradually reduce taxes on income from capital through targeted measures and ensure that tax does not operate as a barrier to international transactions that will continue to become increasingly important to Australia and other countries over time.

Further, the ABA considers that the seven key tax reforms set out in our initial submission to the Review dated 17 October 2008 (**Initial Submission**) remain appropriate. As noted in our Initial Submission, the ABA's proposals are driven by our view on the current problems that affect the efficiency and equity of Australia's tax and transfer arrangements, and how best to address them, as well as our judgment about key future developments that will shape the economic well-being of Australians.

Consistent with the terms of the reference of the Review, the ABA's proposals are directed to four key goals:

(1) Enhancing the international competitiveness of Australia's tax regime.

(2) Ensuring secure access to reliable sources of funding and capital for Australian business and households.

(3) Enhancing Australia's position as a strong and influential financial centre.

(4) Enhancing the certainty and simplicity of the overall tax system, and rationalising its components, in order to mitigate its deadweight cost to Australia.

In relation to the second and third goals, the financial services sector needs access to funding and capital not only for its own growth, but to facilitate its vital role in financial intermediation with the rest of the business sector, with consumers, and with governments. A key issue with access to funding and capital is diversity of source, so that the financial system can withstand periodic and inevitable "shocks".

As noted in our Initial Submission, the seven key proposals we ask the Review to examine are to:

(1) Eliminate interest withholding tax on funding raised from non-residents, including offshore and onshore deposits, by Australian based financial institution groups.

(2) Reduce the nominal tax rate on corporate entities and produce similar effective tax rates across industry sectors.

(3) Increase the after-tax benefit of investment in domestic deposit products.

(4) Create viable options for allocating foreign income to foreign shareholders to address the double taxation of previously taxed foreign earnings of Australian companies caused by the bias of the dividend imputation system against Australian companies with foreign investments.

(5) Streamline the State tax regime by abolishing certain nuisance taxes, harmonising legislation and reforming Commonwealth/State fiscal relations – including the unification of revenue administration and collection.

(6) Simplify the tax law by removing unnecessary specific anti-avoidance provisions which create complexity and produce uncertainty, and ensure more consistent and balanced administration of the tax law.

(7) Implement structural changes to the GST treatment of financial services including the GST-free treatment of B2B financial supplies, or, the GST-free treatment of all financial supplies.

Fuller descriptions of each proposal, and the explanation of how each proposal addresses a priority concern, were set out in more detail in our Initial Submission. Some further elaboration of our proposals is contained in the submission attached to this letter, with references where applicable to discussion of the relevant issues in the Consultation Paper.

As was the case with our Initial Submission, this submission has focussed on specific issues which are of concern to the ABA and its members. The ABA acknowledges that there are many other aspects of the Review and potential problem areas, upon which the ABA has not commented, that are best addressed by other interested parties.

The Review is, appropriately, taking a long term view in its approach to reform. The Foreword to the Consultation Paper states that "while the focus of the review is necessarily on the next 10 to 20 years, the choices made in the years ahead will influence the shape of the tax-transfer system well beyond this period." Accordingly, the current global financial crisis, and the resulting short/medium term impact it is having on the Australian economy, should not detract from the work of the Review and the need for reforms to our tax-transfer system.

The ABA would welcome the opportunity for ongoing consultation with the Review as its work progresses.

Yours sincerely,

Tony Burke

Attachment: "Australia's Future Tax System, Positioning for growth": Further submission of the Australian Bankers' Association to the Review

Australia's Future Tax System

Positioning for Growth

Further submission of the

Australian Bankers' Association

to the Review

1 May 2009

Table of Contents

Australia's Future Tax System

Positioning for Growth

Further submission of the Australian Bankers' Association

to the Review

1. General comments on the Consultation Paper

The first part of this submission contains a broad overview of some of the major themes emerging from the Consultation Paper, so as to provide a general context for the seven matters that were raised in the ABA's Initial Submission. Subsequent sections of this submission provide further detail and elaborate on the matters raised in our Initial Submission.

1.1 Broad policy framework for tax reform

In this section we respond to some of the broader questions posed in the Consultation Paper. A more detailed consideration of some of the issues below appears in **Appendix 1.**

In summary, the ABA considers that there should be no large-scale changes in the way that Australia levies tax, particularly with respect to businesses. Rather, as a mid-level economic power, Australia should determine its general direction for tax changes based on international consensus as reflected in country practice and international agreements, while ensuring that Australia remains an attractive destination for inbound investment and a significant base for outbound investment.

Similarly, in keeping with current international trends, Australia should gradually reduce taxes on income from capital through targeted measures, and ensure that tax does not operate as a barrier to international transactions - that will continue to become increasingly important to Australia and other countries over time (particularly, but not only, problems of more taxation occurring because transactions have an international dimension).

1.2 Income or consumption as main tax base

The economic literature referred to in the Consultation Paper regarding both individuals and business entities, which argues for a total or partial move from an income tax to a consumption tax base in the personal and business areas is highly contestable and contested in economics literature.

Such proposals should be approached with caution and Australia should not commit to a short or long term goal of moving to one or more of the expenditure tax variants found in the literature.

No (major) country has yet done so in a way which has endured and some of the partial moves, such as the relatively longstanding dual income tax of the Nordic countries, demonstrate that the economic efficiency and simplicity claims made about these models are doubtful.

It would only be if the United States or a group of the larger countries in the G-20 made such a move that Australia should consider it. Consumption should play a part in the overall tax mix, but through a broad based GST and specific consumption taxes.

The starting point should be to improve the measurement of income, accepting that it will involve a combination of largely realisation-based measures combined with some appropriate fair value/accruals-based measures in certain situations (e.g. the new taxation of financial arrangements regime). Similarly, a better measure of consumption for the purposes of the GST should be adopted.

In particular, the over-taxation of consumption created by input taxing of much of the activity of the finance industry should be addressed. This over-taxation not only affects the measure of consumption in Australia but also greatly complicates international finance business through the very complex distinctions between input taxed and GST-free financial transactions, and is a detriment to Australian competitiveness in international finance and funds management.

1.3 Targeted measures on income from capital

The modern economic literature does indicate that the traditional apparently self-evident efficiency and equity claims for the comprehensive income tax base ignore household production, household exchange and untaxed forms of leisure. A broad income tax base may not produce the most desirable efficiency and fairness outcomes at the individual level. Departures are justified if they can be shown to produce greater economic efficiency, and either advance fairness, or at least do not have significant adverse effects on fairness.

When looking across countries, it is noticeable that such departures are significant with respect to savings by individuals. There is a general trend increasingly to remove or reduce taxes on individuals' income from capital. Australia already has a number of measures in place which are broadly consistent with international norms in this area (such as the superannuation system and capital gains discount).

Part of the explanation of these measures is a rough and ready adjustment for inflation, which has impacts on income from capital that do not apply to labour income. There are other factors such as the greater mobility of capital, myopic savings behaviour etc. One particular and simple form of individual saving that is currently subject to tax disadvantages is the savings or deposit account. Efficiency and equity will be improved by providing more favourable tax treatment for such accounts and the international trend is in this direction.

1.4 International competitiveness

With respect to the taxation of business and investment income derived through entities like companies, another crucial factor in assessing the tax system is international competitiveness.

Recent economic literature suggests some strong conclusions and policy directions but we advise caution with respect to these findings. The view that company tax is substantially shifted to labour and that the cost of capital is set entirely by international capital markets is hard to reconcile with Australian experience that imputation tax credits lower the cost of capital of Australian companies. We consider that in the normal course of events, the company income tax reaches all forms of return on investment, including economic rents and not just the risk free rate of return.

We consider that similar caution is necessary in relation to suggestions for specific taxes on economic rents, because outside areas like natural resources where the economic rent is generally evident, it is not clear when higher rates of return are an indication of economic rents, or are due to cyclical or other factors. If economic rents are occurring in cases where there is no natural rent, we suggest that the first response should be to address the underlying causes, for example, through competition law or regulation of rates of return to monopolies.

Australia needs to remain in the mainstream so far as the corporate tax rate is concerned, both for general competitiveness reasons and to reduce incentives for income shifting. This will probably require a further gradual reduction in the company tax rate.

Further, it is a better strategy to identify specific cases where shifting of tax burdens can be clearly demonstrated to occur and address those cases. For example, returns on debt capital originating are very sensitive to source taxation and often demonstrably shifted to borrowers. Such taxation raises the cost of funds coming from the international debt markets and narrows the international sources of available funding to Australia. This submission argues for the removal of interest withholding tax in specified situations.

In the case of foreign direct investment (FDI) the traditional international efficiency benchmarks merge the firm and its owners and assume either that the cost of funds is set by the worldwide capital markets at the level of the firm, or that the owners of the firm are resident in the same country as the firm, neither of which is the case for Australia's multinational firms. Moreover, Australia's company tax arrangements treat domestic and international investment differently, by effectively only giving a deduction for foreign tax at the shareholder level, unlike the tax arrangements for collective investment. Perversely Australia is currently increasing double taxation situations in relation to foreign direct investment, including for conduit income.

In the case of international portfolio investment, including where it is intermediated through collective investment vehicles, it is accepted, by contrast, that it is the return at the level of the resident investor that matters in measuring efficiency and that capital export neutrality (implying foreign tax credits) is the appropriate outcome.

Some recent developments in Australia, however, are also detracting from this outcome. Apart from the tax planning pressure that will inevitably be created by the differing tax treatments for the two kinds of investment, the trend internationally is to structure domestic tax rules for resident shareholders to ameliorate the international bias created by additional corporate level taxation, while leaving the corporate tax in place as a major form of source taxation. This is the case in major countries like the UK, US, Germany, France and Canada. By adopting similar outcomes while maintaining imputation, Australia will be an attractive base for both multinational companies and collective investment vehicles. The increasing number of double taxation situations for both foreign portfolio and direct investment must also be addressed.

1.5 State taxes

A move away from State taxes on business produces measurable efficiency benefits, since it improves exports and investment. Efficiency gains can be of a similar order to other significant microeconomic reforms of the past. While the improvement in exports may be reduced by adjustments in the exchange rate over the medium term, the improvement in investment quality is ongoing. The revenue impact could be redressed by taxes on relatively immobile tax bases available to the States and/or additional grants from the Commonwealth out of its increased revenues from the efficiency gains.

Further, harmonisation of the tax bases of a reduced number of taxes used by States will improve the operational efficiency of the State tax systems significantly.

Given the constitutional issues of providing the States with access to broad based taxes (which involve other downsides in any event), it is not considered that significant changes in vertical fiscal balance can occur in Australia but there are possibilities of extending the model established when the GST was introduced which improves the overall tax system in Australia including Federal State financial relations.

1.6 Tax administration

Improvements in tax administration and compliance will have benefits in several dimensions, including some already canvassed above.

Tax administration is an overlooked issue in relation to international competitiveness. Certainty and transparency are highly important in establishing a country as a desirable place for investment and placement of funds management and multinational company activities. Australia will advance competitiveness by having a "one-stop shop" for taxation so far as possible, provided that certainty in tax outcomes can be achieved.

A one-stop shop would also have bottom up benefits in relation to State taxation. Companies with pan-Australian operations would have reduced compliance costs if they have only to deal with one tax administration, and such a framework will facilitate harmonisation of the tax base rules, while leaving States with freedom in relation to rates and exemptions.

At the moment, Australia has too many overlapping anti-avoidance rules in many of its taxes, effectively leaving many tax outcomes to administrative discretion that is not exercised in a consistent way. Such discretions should be removed or significantly reduced in number and scope. Broader operational efficiencies, as well as compliance benefits, will also be produced by these changes in tax administration.

2. Specific reform proposals

The ABA's Initial Submission set out seven key problem areas with the current tax-transfer system that from the perspective of the ABA and its members are especially in need of reform.

The problems were each "mapped" to one or more key themes that should guide the Review's deliberations – that is, to our view about where current problems that affect the efficiency, equity and complexity of Australia's tax and transfer arrangements lie, and how best to address them, as well as our judgment about key future developments that will shape the economic well-being of Australians.

The four key themes that the ABA identified in its Initial Submission were:

(1) Enhancing the international competitiveness of Australia's tax regime.

(2) Ensuring secure access to reliable sources of funding and capital for Australian business and households.

(3) Enhancing Australia's position as a strong and influential financial centre.

(4) Enhancing the certainty and simplicity of the overall tax system, and rationalising its components, in order to mitigate its deadweight cost to Australia.

Having reviewed the Consultation Paper, the ABA considers that the key themes set out above remain relevant and that our seven specific reform proposals are still appropriate and important.

Some further comments on our suggested reforms, including some refinement and elaboration of the proposals, are set out below.

2.1 Access to stable funding and capital: interest withholding tax

Eliminate interest withholding tax on funding raised from non-residents, including offshore and onshore deposits, by Australian based financial institution groups

Our Initial Submission suggested two possible (alternative) exemptions from interest withholding tax for Australian based financial institution groups, one for wholesale funding and one for all funding from non-residents. It indicated that such exemptions would broaden the sources of funds available for Australian financial institutions, the benefit of which would flow through to Australians generally, in the form of lower interest rates.

The Consultation Paper noted this and other similar submissions at page 132, indicating that they were consistent with international trends and with the competitiveness analysis summarised in Table 6.2, as such interest is a normal return in terms of the first row of that table. The Consultation Paper also notes that the revenue raised by withholding taxes generally is low compared to the major taxes on non-residents, being the corporate tax and resource taxes, but points out that the tax reduces the returns from income shifting.

Only thin capitalisation is referred to, but this is presumably intended also to encompass transfer pricing through excessive interest rates and the controlled foreign company (CFC) rules through the attribution of tainted income. The interest withholding tax is estimated to raise $1.3b on interest and interest-like amounts of $36.6b paid to non-residents, at an average tax rate of 2.8%. This revenue is considerably less than what would be raised by applying the statutory rate of 10% to all outgoing interest and arises because of existing exemptions. The difference provides a quantitative measure of the general policy inappropriateness of the interest withholding tax in many international situations. We consider that the application of the interest withholding tax to payments by financial institutions is inappropriate policy and that this is widely recognised internationally.

In our Initial Submission we provided the following indicative measurement of the benefit of such a change:

> *While the exact impact of this policy setting is difficult to calculate, over the 12 months to May 2008 (i.e. before the extraordinary events of recent months set in) the spread between the 6-month AUD LIBOR interest rate and the RBA target cash rate increased by approximately 90 basis points, much of which has been passed on to Australian business and consumers. If even one basis point of this illiquidity-driven increase could be mitigated through better access to overseas funding, it would have reduced the interest burden to Australian borrowers by approximately $116 million, and 10 basis points would have saved interest expenses in the order of $1.16 billion.*

2.1.1 Future market conditions

Since the time of our Initial Submission, the pressures on sources of funding available to Australian financial institutions have changed in a variety of ways. The international financial crisis has deepened, but a combination of the Government deposits guarantee and the flight to quality by investors has led to an increase in bank deposits. Nonetheless, and notwithstanding the Government term funding guarantee, the greater spreads required in international financial markets as a result of higher risk premiums and competition for funds, given that governments are now significant borrowers in the markets, has overall increased the cost of funds internationally for Australian based financial institutions.

This process will possibly reverse itself to some degree in the future but again with offsetting effects – the removal of the guarantees will put upward pressure on the cost of funds while lower risk premiums and declining demand for government borrowing may reduce that pressure. It is the ABA's view that the upward pressure on cost of funds in international markets will exist for some years. We elaborate further on some aspects of current and future funding issues in section 2.3 below.

Moreover, the benefits to Australia as a whole of increasing access to international funding and putting downward pressure on interest rates charged to Australian borrowers are significant compared to the revenue. As appears from the estimates above, a reduction of 10 basis points in interest rates is more or less equivalent to total annual interest withholding tax collections, and from the data below even a 1.5 basis point reduction in cost of funds is likely to equal current collections from ABA members.

2.1.2 Single broad exemption for interest paid by Australian based financial institutions

Having reviewed the current operations of ABA members and the likely future environment, the ABA considers that Australia should adopt a variant of the broader of its original proposals, that is, an exemption from interest withholding tax for funds raised from non-residents by Australian based financial institution groups, including Australian branches of foreign banks. There are three benefits of this approach and very little revenue cost. The benefits are:

- Improved access to offshore wholesale funding not covered by current exemptions, without compliance and tax-risk concerns about any statutory borderline between wholesale and other sources of funding;
- Improved access to offshore retail deposits, without having the current compliance and tax risk concerns raised by the pool of funds approach and other approaches to the application of current interest withholding tax on inter-branch dealings, as set out by the ATO in TR 2006/9; and

- Removal of the significant compliance costs associated with collecting interest withholding tax on the very small number of retail deposits in Australia held by non-resident depositors.

As noted in our Initial Submission, the first two sources are currently not accessed for Australian operations if withholding tax would otherwise apply, which reduces the funding base available while having no direct impact on interest withholding tax revenue. The first bullet point was discussed in our Initial Submission.

In relation to the second area, some ABA members have significant operations in other parts of the world, whether as branches or subsidiaries and in some cases those operations have a large domestic deposit base there. The surge in domestic deposits that has occurred in Australia has been even greater in other parts of the world, particularly in Asia where there are higher savings rates and current account surpluses, so that these foreign operations are likely to be in a surplus liquidity position over the long term.

At the moment, these funds are typically placed in the international inter-bank market by the foreign operation rather than being available for use in Australia, because of the way the interest withholding rules are applied by TR 2006/9 in relation to inter-branch transfers. This is not a criticism of the ruling, which is considered to be a sensible practical application of the current rules; rather it indicates the inappropriateness of the current rules for financial institutions.

The main geographical area that has been identified as the likely source of significant deposit growth is Asia. For banks with substantial operations in this region, it is possible to attract funds locally in Asia but as explained, the deployment of these funds to Australia risks attracting interest withholding tax and so does not generally occur. For banks that do not have substantial operations in Asia, it is possible to attract the funds directly to Australia, but again this does not occur because of the interest withholding tax.

A general exemption from interest withholding tax on such deposits will allow the funds to be attracted to Australia and at the same time permit Australian based financial institutions to attract the deposits locally in Asia or from Australia, as suits the particular operations of individual financial institutions.

There are several reasons why Australia would be significantly benefited by accessing such surplus deposits (and non-resident deposits more generally), which will only occur if no interest withholding tax is levied.

First, most of the funding (up to 90%) is typically regarded as core or "sticky", that is, is left with the bank on a relatively long term basis, even if the deposit is at call or short term. Hence it has the capacity overall to provide longer term funding to financial institutions and not require re-accessing the market on a regular basis.

Second, the cost of such funds is typically 130 basis points below term (5 year) capital market (wholesale) funding.

Third, Australian financial institutions have been criticised by banking analysts and ratings agencies for over-reliance on wholesale funding and under-reliance on deposit funding. As noted above, it should be possible to lower the cost of funds of wholesale funding if there is wider access to the sources of such funds without the imposition of interest withholding tax, but in order to address the risk of an effect on credit ratings or market perceptions of Australian financial institutions at the same time, it is necessary to increase the deposit funding base of Australian banking operations[1].

In relation to the third area, interest withholding tax of small amounts in terms of the overall domestic deposit base of Australian financial institutions is currently collected with considerable compliance costs which are high in relation to revenue collected. Many of these cases involve individuals who are often unaware of the implications of the deposits, for example, non-residents who own rental properties in Australia and maintain a bank account for receipts of rent and payment of expenses,[2] foreign parents who have children undertaking education in Australia and maintain a bank account for the children to draw on, [3] and Australian expatriates posted overseas who keep bank accounts in Australia.[4] The total interest withholding tax collected by a group of the larger ABA members is estimated at $154m, of which at least one third comes from retail deposits. The data are provided in **Appendix 3**.

A single interest withholding tax exemption for financial institution groups operating in Australia solves all of these issues with only a small direct revenue cost. The ABA considers that this should be the preferred approach.

2.1.3 Related party interest

The exemption suggested above would have no adverse impact on the income shifting issue if the exemption is confined to raising funds from unrelated parties. We have already noted the view in the Consultation Paper that the interest withholding tax reduces the incentive for profit shifting. We are strongly of the view that the proposed exemption does not require a general related party exception. If such an exception is considered necessary, the exemption should

---

1 See ***Appendix 2*** for more detail and data on this important issue.

2 Although dealing with different issues, *Lilydale Pastoral Co Pty Ltd v Commissioner of Taxation* [1987] FCA 98 is indicative of the kinds of issues to which ownership by non-residents of investment properties in Australia gives rise. In addition to the situation in the text, interest withholding tax issues also arise if a non-resident has borrowed from a non-resident bank to fund a rental property investment in Australia.

3 See Trisnawati Tanumihardjo v Commissioner of Taxation [1997] FCA 735 for an example of the problems to which this situation can give rise.

4 Australia recognised and dealt with this problem in relation to foreign expatriates resident in Australia who have loans from foreign banks on which they pay interest to the banks in *Income Tax Assessment Act 1997* s.768-980 but does not deal with the converse case of Australian expatriates overseas with deposits in Australian banks.

nonetheless be available where an entity is part of the Extended Licensed Entity (ELE) group and on-lends to the ADI in the group.

The ELE group is a concept used by APRA in its prudential regulation of ADIs to allow other entities besides the ADI itself to be within the regulatory regime with the benefits and burdens involved. The ELE rules require that any such entity be 100% owned by the ADI and that funds raised by the ELE entity are on-lent to the ADI. The rules use a single entity approach somewhat similar to tax consolidation (that is, the members of the ELE group are regarded as part of the ADI). The difference from tax consolidation is that it is possible for a foreign entity to be part of the ELE group.

This, however, should not give rise to profit shifting concerns. APRA has rules in place to prevent the ELE rules being used to circumvent prudential requirements. As the thin capitalisation rules for ADIs are based on regulatory capital, these APRA requirements in effect ensure that thin capitalisation rules will not be misused by an ELE group. Moreover it will generally be necessary for the ADI to give a guarantee for any fund raising by foreign entities that are members of the ELE group, with the result that only a very small margin can be charged by the foreign entity for on-lending to the ADI. Hence the risk of transfer pricing is small and relatively easy to audit in such cases.

The availability of the proposed exemption is necessary for foreign entities which are members of the ELE group because in practice, the interaction of foreign and Australian regulatory issues, including taxation, may mean that the only way to access particular sources of foreign funding is through a related offshore party.

In order to enable Australian financial institutions to surmount such hurdles in accessing foreign funds, the ABA considers that any limitation relating to loans or deposits from related parties should not apply to members of the ELE group.

We note that, in the case of financial institutions, the thin capitalisation and transfer pricing rules are sufficient to deal with income shifting problems (with the added comfort provided through the attribution of tainted income under the CFC provisions) and no related party qualification to the exemption should be necessary. The ABA would wish to meet with the AFTS Treasury Secretariat to discuss the issue if the view is taken that a general limit excluding related party loans should apply to the proposed exemption.

2.2 International competitiveness: corporate tax rate

Reduce the nominal tax rate on corporate entities and produce similar effective tax rates across industry sectors to the extent possible, consistent with international patterns

In our earlier discussion of the general policy settings for the tax system in general and for the business tax system in particular, we noted why we consider that some of the economic analysis referred to in the Consultation Paper needs to be approached with considerable caution, and why we consider that the issues of the corporate tax rate and the corporate tax base are generally separable.

In our view there are several factors which affect the choice of the corporate tax rate. So far as the tax base is concerned, we consider that there should be two objectives – first, generally ensuring a correct measurement of income/profit for tax purposes, and second, providing targeted measures for reducing tax on income from capital, where it can be demonstrated that this will increase economic efficiency without significant effects on fairness.

2.2.1 Corporate tax rate

In our view the Review should set a medium term goal of reducing the Australian corporate tax rate to no more than 25% and that the rate needs to be periodically reviewed to judge whether it remains appropriate. This is consistent with the policy approach in Australia in the last 20 years, which in our view has generally served Australia well.

Table 6.2 in the Consultation Paper suggests that there is some policy tension between the corporate tax rate and the measurement of the corporate tax base. As noted above we consider that this approach needs to be treated very cautiously.

In terms of the tax rate we consider that it is evident from everyday observation and the systematic studies undertaken by the OECD that there is international tax competition, and that Australia needs to take this competition into account in setting the rate. As discussed further in 2.4 we see the major international function of the Australian corporate tax rate as affecting direct investment into Australia and portfolio investment into Australian companies. We do not consider that the rate has a significant role to play in taxing outbound investment from Australia – that is a matter for the corporate tax rate in the countries in which such investment is made.

In judging competitiveness, we need to look first at the Asian region. The two cases where the tax rate matters is where a foreign multinational is considering direct investment in the Asian region and is considering where to place that investment, and where a foreign fund manager is looking to make portfolio investments offshore and is looking at Australian listed companies as part of diversifying into the Asian region. The corporate tax rate issue in Asia is different to the Americas and Europe.

In the Americas the tax rate is high, but many companies consider they have little choice but to access the huge US domestic market. Australia is generally not competing for investment against the US or Canada. In relation to Europe, the corporate tax rates are trending downwards, but are not generally as low as in Asia. The downtrend however is likely to be more rapid because of some significant low tax jurisdictions on the edge of major European countries, particularly Ireland and Switzerland. Because of EU non-discrimination and other rules as interpreted by the European Court of Justice, European countries are unable to counter the issues created by low tax jurisdictions in the usual ways such as broad Controlled Foreign Company (CFC) rules. Switzerland also benefits from these rules through the European Free Trade Association (EFTA) although not a member of the EU.

The Asian region is not generally a competitor with Europe for investment, as most multinational corporations will wish to access the substantial markets in both Europe and Asia. In Asia, while corporate tax rates are overall lower than in Europe or the Americas, they are still generally levied at substantial rates and are not so affected by the Irish/Swiss issue, as the same constraints for dealing with low tax jurisdictions, for example by CFC rules, do not apply in Asia.

As noted in our Initial Submission, a review of rates in Asia suggests a lowering of the corporate rate in Australia. Although we did not put a number on it in that submission, we consider that 25% is an appropriate target rate because a 5% cut would be viewed as material by foreign investors but would maintain Australia as a mid-level rate country in Asian terms, and retain a sufficient tax on economic rents derived in Australia, particularly in the resources sector (and in any event, taxes on resources can be levied in other ways).

Turning to some more specific factors with respect to the rate, the way in which taxes are treated in financial statements highlights the tax rate. Income tax expense in such statements is calculated by applying the statutory rate to the pre-tax profit while the effects of the tax base differing from the financial profit appear in the tax effect accounting adjustments. When foreign firms evaluate Australian investment projects, the tax rate appears as a major impediment as it is much more difficult to construct the impact on tax effect accounting for a prospective investment.

Moreover, it is clear from recent economic analysis that one major effect of the headline corporate tax rate is its impact on incentives for income shifting. This effect is particularly evident in the US because of its now relatively high corporate tax rate. Having a mid-level rate in Asia with respect to the corporate tax rate will reduce incentives for income shifting out of Australia whereas over time the current rate is increasing those incentives.

2.2.2 Corporate tax base

As we think that the income tax reaches all forms of return we consider that there should be an accurate measure of income on one hand and, where competitiveness or efficiency demands, targeted departures from that measure.

We highlighted a number of issues in our Initial Submission. While we consider that the matters identified remain important, some of them such as OBUs, are we understand being discussed outside the Review. Here we focus on what we consider to be the major mismeasurements of income in the Australian system, the related issues of intangibles and black holes. We focus on this area as intangibles are becoming major assets around the world and the current treatment generally leads to the over-measurement of income and permanent differences, not timing differences.

In relation to targeted measures we consider that the priority is in the area of individual savings rather than the corporate tax base. We take up this specific issue in section 2.3 below.

The black holes/intangibles issue has been the subject of consideration by Government several times in recent years. The Ralph Review recommended and the Government adopted economic depreciation as the basic policy. Since that time the ATO has gradually worked its way through its tables of economic lives for tangible assets to give effect to the change in legislation. As a result, there has been an on-going increase in revenue from this reform not just a one-off effect in 1999. In some specific cases the Government has adopted caps on effective lives where an economic life approach would cause economic damage to Australia, because of international competitiveness issues, for example, in relation to large aircraft used by international airlines.

In relation to intangible assets and black holes, the Recommendations of the Ralph Review were to follow a similar approach, except that there was to be no write-off for acquired goodwill. At that time, the accounting standards allowed a write-off of acquired goodwill but the business members of the Review did not regard that approach as appropriate. There were also revenue cost issues, and an argument that it would be necessary at the same time to make changes to the tax treatment of internally generated goodwill.

The Ralph Review saw the change for intangibles and black holes being developed as part of adoption of the tax value method. That method did not proceed and the Government therefore had a separate reform exercise for black holes. The result was that a wider recognition of intangibles occurred through amendments to s 40-880, but generally the changes were limited, in particular, if an expense formed part of the cost base of a CGT asset.

The effect of this approach has been to produce an all or nothing deduction for many acquired intangibles. Over the years the courts have been troubled by the inappropriate denial of deductions of costs, giving rise to wasting assets, and accordingly have often held them to be revenue rather than capital, in which event they are immediately deductible. Not surprisingly the ATO has resisted such immediate deductions, giving rise to a great deal of litigation involving large amounts of tax revenue. Many years ago a judge commented that the results in these cases were as unpredictable as the toss of a coin and the recent cases bear out this comment. Not surprisingly, about as much revenue is lost through cases lost by the ATO as gained though wins by the ATO.

It is suggested that a more systematic and policy based approach should be applied to this issue. Since the Ralph Report and subsequent review of black hole expenditure, the accounting framework has changed significantly as a result of the adoption of A-IFRS commencing in 2005.

In response to an inquiry from the AFTS Treasury Secretariat in relation to our Initial Submission, on 24 November 2008 we provided detailed information about the current accounting treatment for intangibles acquired in a corporate takeover or merger transaction which reflects the A-IFRS treatment. Under that treatment the acquiring entity is required to identify in considerable detail the wasting intangible assets acquired, to determine an economic life for them and to amortise them in future financial reports. The residual acquired intangibles are treated as goodwill and not amortised but rather subject to impairment testing. Write-offs are only required for the goodwill if on testing it is found that the carrying value of the acquired goodwill has been impaired.

We consider that this framework provides an appropriate treatment (compared to the previous accounting treatment) and propose that a variant of it be adopted for tax purposes, that is:

- acquired intangibles which are separately identified on an acquisition and assigned an economic life should be amortised on a straight line basis based on that life (which may be reassessed under current tax rules) but no deduction be permitted for other impairment of the intangibles until disposal;
- residual acquired goodwill will continue not to be amortised, nor deducted on the basis of impairment but only recovered on sale; and
- acquired intangibles which currently qualify for immediate deduction under case law be required to be amortised if identified and assigned an economic life for financial reporting purposes on acquisition.

We consider that this change is likely to be generally revenue neutral, while considerably improving the measurement of income, and fairness between taxpayers, which will no longer be subject to a toss-of-the-coin result. We set out in **Appendix 4** some of the intangible assets in current accounts of ABA members. While the amounts are not large in terms of overall assets, the current rules create particular distortions when acquisitions are made, and such acquisitions continue to occur on a regular basis in the financial institution area and are likely to be more common in future years as the current adjustment and consolidation of the sector proceeds. Our estimates is that over a two year period there is about one billion dollars per annum in this category for ABA members, compared to acquired goodwill of around $16b. The data are provided in **Appendix 4**.

As well as being important on a domestic basis, the issue is particularly important internationally. Many countries have in recent years adjusted their tax rules in this area to align more closely with financial accounting. As a result, Australian business may be at a competitive disadvantage and Australia may not be viewed as a desirable location for international businesses when deciding on investment location for businesses with significant levels of intangibles.

2.3 Access to stable funding and capital: increase the after-tax benefit of investment in domestic deposit products

We have noted above that we consider that targeted measures are appropriate for economic efficiency reasons when it can be demonstrated that the normal measurement and taxation of income produces economic distortions. In this section we consider such measures in relation to individual savings through deposit type accounts. The discussion here needs to be considered along with section 2.1 of this submission. There we indicate why in our view a broad exemption from interest withholding tax for Australian based financial institution groups is necessary, including for offshore and onshore retail deposits from non-residents. In this section we consider the complementary issue of savings deposits by Australian residents.

The Initial Submission set out in detail (at para 4.3 and Appendix 1) the case for a measure to increase the after-tax return to holders of domestic bank deposit products. This part of the submission updates that case and provides further detail on the scope and operation of such a measure.

2.3.1 Background – the changing environment since October 2008

The Initial Submission supported the proposal for a tax-preferred savings product for a number of reasons. In this part of the submission, we update that discussion for the changes that have occurred as the Global Financial Crisis has deepened and for the effect of the Prime Minister's announcement of 12 October 2008 of a 3-year uncapped guarantee of deposits in all Australian banks, building societies and credit unions.

The Initial Submission detailed the serious decline in the proportion of bank funding sourced from domestic deposits. While the Prime Minister's announcement has undoubtedly seen an increase in the level of deposits, it has not eliminated the problems described in the Initial Submission, because the other side of the coin – the ability of banks to source funds from issuing other kinds of debt instruments in Australia and overseas – has become commensurately more difficult over the same period.

Rolling over wholesale funding remains exceedingly difficult because of the financial crisis. Moreover, the increase in the level of domestic bad debts has had an obvious impact on the ability of banks to rely on current earnings as a source of further funds. Such an environment heightens the significance of deposit products as a source of funds for domestic banks, leaving the banking system heavily reliant on unstable and increasingly expensive foreign wholesale funding. It has also seriously constrained the ability of banks to be able to pass on to borrowers the full benefit of the series of reductions to the cash rate set by the Reserve Bank.

An additional element is that margins between domestic deposits and loans are also declining because of the competitive pressures to attract deposits. In our view the relative rise in interest rates on deposits that is occurring (compared to the Reserve Bank rate) reflects some degree of capitalisation of the tax disadvantage suffered by deposit accounts, partly caused by investors who are switching from relatively more tax favoured investments.

The Initial Submission also noted the increasing trend of OECD countries to provide some form of tax-preferred accounts as a means of improving low rates of national saving. This reflects a general concern that the over-taxation of interest may impair economic efficiency by discouraging saving.

While there is obviously a concern that incentives for one form of investment may result in the diversion of savings rather than an increase on overall levels of saving, the OECD report Encouraging Savings Through Tax Preferred Accounts has concluded that tax preferred accounts can induce new savings from moderate- and low-income households. Making a tax-preferred savings product attractive to low and middle income households is also necessary to ensure that the product does not detract from the equity goals of the tax system. The significance of this issue has not been diminished by the events of the last 6 months.

Another set of arguments advanced in the Initial Submission concerned the economic inefficiency induced by the differential tax treatment of various savings options, and in particular by the embedded over-taxation of bank account products compared to the tax treatment afforded to other classes of investment product – owner-occupied housing, rental property, listed shares and superannuation – which enjoy various types of tax concession, as demonstrated in the Architecture Paper.

Effective marginal tax rates on bank accounts in Australia are very high when the erosion of interest earnings resulting from inflation is taken into account. Further, the tax-free status of superannuation benefits after 1 July 2007 for individuals at 60 years of age, when combined with the tax-preferred treatment of superannuation contributions and earnings, creates a very sizeable disincentive for individuals to save directly through deposit products. These very high effective tax rates on direct savings are likely to be one factor behind the high loan to deposit ratio of Australian banks. The Government guarantee does not address this issue.

Nor does it address the international competitiveness issues – that is, the relatively high rate of tax on interest income imposed by Australia compared with other OECD countries. Given that the location of direct saving is likely to be very sensitive to tax rates, the ability of Australian banks to retain the savings of domestic depositors and, more importantly, to attract savings from foreign customers, is obviously adversely affected by this position.

In summary, a tax-preferred savings account designed along the lines discussed below could assist in achieving a number of desirable policy outcomes:

- making the Australian economy less vulnerable to international financial shocks because of the proportionately reduced need of Australian banks to rely on foreign wholesale funding sources;
- assisting in increasing aggregate levels of national saving;
- increasing the effectiveness of Reserve Bank decisions by strengthening the direct impact of changes to the domestic cash rate; and
- removing the inefficiencies created by the differential treatment in the tax system of other currently tax-preferred forms of saving.

The remainder of this part of the submission outlines how a tax-preferred savings product could be designed to assist in achieving these goals without, at the same time, diminishing equity, increasing administrative complexity and compliance cost or generating an unwarranted cost to the Budget. The opportunity to participate in a tax-preferred deposit product must be made attractive to households with a low marginal propensity to save. Overseas experience, particularly in Canada and the UK, shows several possible designs that attempt to deliver a measured preference in a way that does not seriously erode equity, increase complexity for tax administrators, impose significant new compliance costs on taxpayers or challenge Budgetary goals.

2.3.2 Design options

The Table below proposes three possible models for a domestic deposit product which delivers higher after-tax returns to depositors. The proposal is for the introduction of three discrete regimes because each has features that will appeal to different segments of the market. The key difference between each product is the mechanism for delivering the incentive: a Government co-contribution, tax deferral or tax exemption.

Table 1: Representative Tax-preferred Savings Products

	Existing equivalent product	**Features**	**Target market**	**Limits / parameters**	**Maturity**	**Potential changes**	**Name**
Supported Savings Product	First Home Saver Account	Government co-contribution Concessionally taxed at source Limited to specific purpose	All ages Middle income	Deposits of $1,500 – 2,000 per annum	3-5-10 yrs	Govt co-contribution to go to super	"Savings Builder" "Nation builder"
Tax Deferral Product	Farm Management Deposit Scheme	Deposit is a deduction Interest assessed each year Deposit taxed on withdrawal	Middle age Middle income	$10,000	5-10 years	Interest not taxed or taxed at maturity	"Tax Management Deposit"
Tax Exempt Product	None in Aust (examples from remainder of developed world)	Interest exempt or taxed concessionally	Younger to middle age (later age if product combined with exclusion from pension asset testing)	$5,000 per annum	3-5-10 years		"Savings Builder" "Nation Builder"

2.3.3 Australian experience with comparable savings products

The first two options deliberately draw on the design of existing banking products. For example, the Tax Deferral Product resembles the existing Farm Management

Deposit accounts and the Supported Savings Product resembles the First Home Saver Accounts. This has two benefits:

- the existing administrative systems of Australian banks should be readily able to accommodate the new product(s); and
- some intuition about the outcomes of each proposal can be gleaned from past experience with existing products.

So far as systems compatibility is concerned, there are existing tax preferred products currently available through the Australian banking system. To date, the limits on availability of the products to particular banking customer segments have resulted in under-investment by banks in the development of the systems to support these products. However, using existing products as the basis for generally available tax preferred savings products will simplify implementation and deliver a critical mass of customers to permit sizeable investment in efficient product maintenance and administration.

So far as prior experience is concerned, in the Australian context, the product with the longest history is the Farm Management Deposit (previous incarnations include the Income Equalisation Deposit and Farm Management Bond schemes). There are, therefore, readily available statistics to facilitate the analysis of a product based on this design.

Whilst only available to eligible primary producers, its take up has grown from 6,022 users and $228.6M on deposit in June 1999 to 38,401 users and $2.5B in March 2008. Participation has matured and stabilised at about this point in recent years. A Review of the product undertaken by the Department of Agriculture Fisheries and Forestry in November 2006 concluded it was meeting its policy objectives as a tax-linked financial risk management tool to encourage greater farm resource optimisation through financial flexibility. The Review highlighted that a large proportion of users (over 50%) were middle income farmers, but it concluded that the product did not discriminate across income segments.

The First Home Saver Account has only been available from 1 October 2008 and so little can be drawn regarding effectiveness. It must be noted that the complexity of design, particularly around tax collection and transfer administration, has hampered the take-up to date.

2.3.4 Target Market Segment

To ensure the widest possible application, it is appropriate to consider offering a selection of products to match the behavioural needs of the different segments.

Overseas analysis identifies that it is imperative to offer a product that attracts the discretionary savings capacity of low- and middle-income earners in order to grow national savings. Given the changing demographic due to baby boomer retirement, it is also relevant to consider the incentives necessary to encourage self funded or partially pension-reliant older Australians to direct savings towards longer term, lower risk savings products.

In this respect, consideration should be given to ensuring the deposit balance is excluded from assets testing for pension and other social security purposes.

For all products it will be necessary, in order to be consistent with the objective of growing national savings, to ensure that customers are not permitted to borrow to invest in and access the tax-preferred returns of the products. This could be achieved by denial of interest deduction for tax purposes.

2.3.5 Cost

It is recognised that it will be necessary to set appropriate limits on participation and benefits, to minimise the tax cost of the proposals. To mitigate the budgetary implications of high participation by high income households, caps are included in each design. This would allow the low- and middle-income sections of the community to participate, without excessive benefits flowing to high income households.

2.4 Access to stable funding and capital and international competitiveness: double taxation

Eliminate international double taxation including the creation of viable options for allocation of foreign income to foreign shareholders to address the double taxation of previously taxed foreign earnings of Australian companies caused by the bias of the dividend imputation system against Australian companies with foreign investments

Our Initial Submission was limited to the issue of allocating foreign income to foreign shareholders in relation to the imputation system. In making that submission, it was understood that the Treasury view of this issue was based on national neutrality or national welfare, and was in favour of an effective deduction of foreign tax system, on the basis that payment of foreign tax provides no benefit to Australia, while payment of Australian tax does. The submission sought to demonstrate the problem that this policy can only operate asymmetrically in the current international environment. Specifically, foreign losses reduce the Australian tax base in full, and not in their after-tax amount, because the losses are generally denied in the foreign country for tax purposes because of liquidation or because of the operation of foreign equivalents of Australia's continuity of ownership rules.

The Consultation Paper deals with this issue at pages 139-141. The discussion repeats the Treasury position about national welfare without addressing its asymmetric operation. The Paper also makes the points that allocation is already possible for dual listed structures and that it raises the broader issues of whether it should also apply to foreign multinationals with Australian operations and Australian shareholders. The ABA agrees that the issue needs to be looked at in a broader context and in the context of international double taxation more generally, particularly as this issue has become a greater concern to ABA members in very recent times.

The discussion here assumes the continuation of imputation, on the basis that Australian markets have a significant impact on the cost of capital of Australian companies, that the company tax is not significantly shifted, and that it provides the best available solution to double taxation of companies and shareholders. These issues are discussed elsewhere in this submission.

It also assumes that in accordance with the Government's desire to make Australia a regional financial centre and the current Board of Taxation Review of the taxation of managed investment trusts, the treatment of portfolio investment in an international sense will continue with a foreign tax credit paradigm for resident investors, and effective full conduit treatment for non-resident investors in Australian funds.

The Consultation Paper discusses the international benchmarks of CEN and CON (CIN) at page 139. While that discussion is near the imputation discussion in the paper, it does not recognise the very different outcomes under the differing regimes, in particular CEN/CON on the one hand and national welfare on the other, nor the problems of seeking to maintain both simultaneously. This submission seeks to bring these matters together, starting with some specific recent actions in tax legislation and administration that demonstrate the tensions.

2.4.1 Increasing international double taxation in Australia

By way of context it needs to be understood that tax and other issues in international investment have led to a proliferation of different types of entities that are generically referred to as "hybrids", in the sense that they are treated as tax transparent in at least one country with which they are connected. In structuring both direct investment into and out of Australia and funds management of portfolio investment into and out of Australia, there is no choice but to use hybrid structures if an investment is to occur, as the investors from other countries involved or the investment out of Australia into foreign countries will demand them. A general purpose of hybrids is to prevent international double taxation, which is consistent with the internationally agreed tax policy.

All countries around the world permit such transparent structures, in many cases, including Australia, introducing new such forms into domestic commercial law and adjusting tax law to give them flow through tax treatment. In Australia the new legal form is the incorporated limited partnership used for venture capital activities, and the adjustments of tax law to give flow through treatment have occurred in relation to venture capital and foreign hybrids involving limited partnerships (and some other forms of foreign entities in the case of the latter). More recently, that treatment is being reversed in Australia with the result, at the least, that foreign tax is effectively deductible rather than creditable (or in some cases much worse outcomes).

We provide here one example in the area of tax legislation, and several in the area of tax administration, of this trend to create international double taxation. In the new foreign income tax offset (FITO) legislation that commenced operation in mid 2008, the previous foreign tax credit that applied in the context of second tier foreign investment funds (FIFs) using the calculation method was removed, leaving an effective deduction for foreign taxes. The policy justification for this change can only be read as an application of the national welfare policy. This change is causing significant difficulties in the case of portfolio funds management investments out of Australia. Difficulties also arise for direct investments but the focus here is on portfolio investment.

In many funds management structures, in order to accommodate investors from different countries, a foreign hybrid will be placed in an offshore jurisdiction and from there investment will be made in entities in one or more major countries. Previously it would often be possible to obtain foreign tax credits for the taxes levied in the country of ultimate investment, but that is no longer the case. The result is either that the investment can no longer be made out of Australia, or that such investment is more costly because special structures have to be created for investment coming from Australia. In either event Australia is disadvantaged as a funds management hub.

The administration of the foreign hybrid rules which were designed to facilitate Australian investment overseas on a flow through basis contributes to this problem. The ATO has recently ruled in TD 2009/2 that the foreign hybrid rules do not apply to hybrids located in such offshore jurisdictions, so that a possible remedy to the problem created by the denial of a FITO for a second tier FIF is not available. Some other rulings mentioned below in the case of direct investment also have significant adverse effects in the area of portfolio investment.

For direct investment, the ATO has released a number of rulings that have caused considerable dislocation. In three rulings issued in the second half of 2008, TD 2008/23-25, the ATO has denied the participation exemptions for corporate foreign direct investment as modified or introduced in 2004, where there is a partnership or trust involved in the structure. These rulings effectively undo much of the work intended to be achieved by the 2004 changes.

A significant reason for the introduction of these exemptions was one part of the solution for making Australia a base for regional business operations by providing conduit treatment for income that passed through Australia – the income or gain would be exempt on receipt in Australia and would not be subject to dividend withholding tax or capital gains tax when paid out to or realised by non-residents. Now the gains realised onshore are subject to corporate tax through the denial of the participation exemptions.

As the former underlying foreign tax credit has been repealed, the result at the corporate level is an effective deduction for foreign taxes. In the case of resident investors in the Australian company, the outcome is a timing difference, but for non-residents the conduit treatment simply fails to operate as intended. Australian corporate tax is now collected in clear contradiction of the policy intent. The result is that Australia is now less attractive as a base for multinational business activities than was thought to be the case in 2004.

Most recently the ATO has released a draft ruling on the interaction of the FITO and the foreign hybrid rules, TR 2009/D1. This ruling if finalised in its current form will further undermine the position of Australia as a base for investment either portfolio or direct. The draft expresses the view that if a foreign hybrid which has made an election to be treated as a partnership has an interest in a controlled foreign company (CFC) or company-form FIF, then an Australian company which is a member of the hybrid is not entitled to a FITO for tax paid by the CFC in respect of attributable income even if it has a 100% interest in the CFC and foreign hybrid. The result again is the equivalent of a foreign tax deduction or worse in conduit situations.

2.4.2 Addressing international double taxation

We have set out these recent events at some length not for their own sake, but because they appear to represent a trend to a broader application of the national welfare approach by converting what were thought to be, or clearly were, foreign tax credit or exemption situations into effective foreign tax deduction cases. This is occurring across both portfolio funds management and direct investment cases, and in particular is undermining conduit treatment adopted as a firm policy for both portfolio and direct investment in the 2003 Budget.

As noted earlier, the international position with respect to portfolio investment, putting aside for the moment investment in companies, is CEN given effect to by a foreign tax credit. Incursions into this area of effective foreign tax deduction treatment is undermining the competitiveness of funds management in Australia while the current Government objective is to enhance the position of funds management activities in Australia. That objective cannot be achieved without acceptance at the least of the international norm of a foreign tax credit.

In the case of investment in companies, whether foreign direct investment by one company in another, or portfolio investment through a collective investment vehicle in a listed company, the international trend for outbound investment is to produce a foreign tax credit outcome at the shareholder level. This means that there is consistency with outcomes for the ultimate resident investor for investment in companies, as for investment in other asset classes through collective investment vehicles (particularly land and bonds). In the last decade the US, UK, Germany and France, to name some major countries, have made changes to their company tax systems that produce that outcome for the ultimate resident investors in companies.

The purpose of the corporate tax in an international setting (as opposed to its possible domestic purposes of preventing deferral and acting as effectively a withholding tax on shareholders) is nowadays as a source tax on business income. The Consultation Paper notes that the tax is effective for this purpose in Australia.

The company tax does not serve in these other countries as a means of achieving an effective foreign tax deduction system for foreign tax and a national welfare outcome. On competitiveness grounds alone that should indicate a similar policy direction for Australia. There are, however, at least two more important reasons for this outcome.

Firstly, in an era when globalisation of business has occurred and global threats such as climate change or concealment of income from tax are the focus of international action, it is clear that policy needs more generally to be focussed on global welfare as that is the only policy which can address the collective action problems produced by a national welfare focus. This is particularly evident in relation to climate change: if each country judges international action by the effect on that country's national welfare only, nothing will happen.

Secondly, although the distinction between portfolio and direct investment, and between investment in companies and in other forms are convenient for the purposes of policy analysis, they are distinctions that are very difficult, if not impossible, to maintain in the real world. This is demonstrated by the continuing problems that have occurred of drawing the line between the CFC and FIF regimes and crossover between them. More broadly it is not possible to maintain a policy of effective foreign tax deduction in relation to direct investment and a foreign tax credit for portfolio investment. The rest of the world has realised this and is adjusting tax systems to the foreign tax credit result while moving to full exemption systems at the corporate level amongst other things, to produce effective conduit tax treatment in both portfolio and direct investment situations.

Australia cannot hope to retain, let alone increase, its position in the world as a base for funds management activities and business operations if it departs from the policy norm in ways disadvantageous to taxpayers. We consider that legislation should be amended to reverse the specific results, causing increased international double taxation set out above and that Australia more generally should reverse the trend towards national neutrality as the policy goal of taxation of outbound investment, particularly bearing in mind that a not-inconsiderable proportion of such investment is of a conduit nature.

2.4.3 Adjustments to imputation

This discussion gives the full context as to why Australia needs to adjust its imputation system to recognise the payment of foreign tax and produce an effective foreign tax credit result at the level of the investor. In the context of imputation there are two methods to achieve this result, the granting of credit at the level of the shareholder for foreign tax (for which a variety of mechanisms are possible), or allowing the allocation of foreign income to foreign shareholders. In our Initial Submission we gave our reasons for preferring the latter approach and we adhere to that position on the basis that it is already possible for dual listed structures and in our view less susceptible to integrity problems than the alternative.

The need for action is supported by data on the uptake of recent equity issues by ABA members in **Appendix 5**, which show that a greater proportion was taken by domestic investors than non-residents, compared with the overall shareholding profile where foreign investors make up about 22.5% of shareholders but took up only 16.3% of recent equity issues.

The Consultation Paper suggests that our preferred approach involves further issues of allowing a similar result for Australian investors in foreign multinationals that pay Australian tax, with an implication that the same issue does not arise for the alternative of allowing credits to Australian investors in foreign companies. We do not agree with this implication. The question of how to deal with this situation arises in both cases. To date the international policy position is more divided on the latter issue. The US and German systems effectively extend the result to investment by US or German resident shareholders in foreign companies, the UK and Canadian systems do not. In its recent 2009 Budget, however, the UK has announced measures that appear to move in the direction of the German and US systems.

We consider that Australia does not need at this stage to take that policy step in the light of the current international position. If, however, the policy stance were to change, as is not unlikely because of a strong international trend in that direction, then the allocation system provides in our view a simpler way of achieving the result compared to the credit route.

2.5 Certainty and simplicity: State taxes

Streamline the State tax regime by abolishing certain nuisance taxes, harmonising legislation and reforming Commonwealth/State fiscal relations – including the unification of revenue administration and collection

We have noted in our general response to the overall major issues in the Consultation Paper that we do not consider that it is possible to achieve more vertical fiscal balance within the Australian federation due to the Constitution. That does not mean, however, that significant improvement in both State taxation and Federal-State financial relations cannot be made. Here we canvass four specific issues: the removal of State taxes on business; the removal or reform of payroll tax; the rationalisation of administrative arrangements for tax collection in Australia; and the way forward for Federal-State financial relations.

2.5.1 State taxes on business

We referred above to the efficiency argument to removing State taxes on business, particularly stamp duties including conveyance duty. The economic case for this change has been elaborated in a study by Access Economics that has already been provided by the Financial Industry Council of Australia. The specific taxes concerned, which vary slightly from State to State, have been identified by the Commonwealth in the recent past so we do not list them here. In our submission we went further than this list, particularly in the area of insurance. The efficiency benefits are improvements in the quality of investment and the volume of exports. While the latter benefit may be offset over time by adjustments to the exchange rate, the micro-economic reform benefits in relation to investment are ongoing.

2.5.2 Payroll tax

Some of the arguments about payroll tax were included in our Initial Submission and are not repeated here. We note that the Consultation Paper at pages 191-192 makes an efficiency case for the tax compared to other taxes. The main issue concerns the impact on the relative cost of capital and labour of the payroll tax. As recent reductions by some states in payroll tax in response to the rise in unemployment show, the States at least consider that the tax does have detrimental effects on employment. The move to a services economy and the rise in the value of intangibles in effect mean that an increasing share of business value is created by labour rather than capital.

The EU has been similarly concerned with the impact of high rates of VAT for similar reasons and has extended its trial of a permitted lower rate of VAT on labour intensive service industries until 2010. The impact of payroll tax has to be viewed in a context where Australia has recently had a shift away from personal income tax to a consumption tax in the form of the GST.

In that context the combined GST and payroll tax rate begins to approach the rates in the EU and so should give rise to similar concerns. While there are payroll taxes in the EU in the form of social security taxes these go to finance pension benefits related to the previous wage rate and so are comparable to Australian superannuation arrangements. It is taxes on payroll that do not provide specific benefits back to employees that drive a wedge between the tax treatment of labour and capital as business inputs. In our view this suggests a considerable roll-back in payroll taxes or their abolition as the best tax policy.

If that policy position is not adopted then at the very least there should be complete uniformity of the tax base for the payroll tax in Australia with the only differences being in certain limited types of exemptions and tax rates. There should also be uniform (that is, a single) administration as elaborated under the next heading.

2.5.3 Single administration of State taxes

Our Initial Submission supported the transfer of tax administration of State taxes from the States to the Commonwealth in a single revenue administration. We continue to support this approach. In order to achieve such a transfer in our view it would be necessary to significantly restructure existing administration arrangements by at the very least providing for direct State input into the tax administration process through a revenue board that would oversee tax administration of all taxes in Australia. There is an on-going trend in this direction overseas (unification of various taxes in a single tax administration under a board structure). In setting up such a structure, the opportunity should also be taken to have private sector representation on such a board as outlined further below.

It would be possible to transfer some but not all of the State taxes to such a unified administration. The criterion for drawing the line would generally be that similar or complementary taxes should be administered in a unified way. At the request of the AFTS Secretariat we provided examples of this principle in relation to payroll tax and FBT in a letter of 24 November 2008. At the moment the tax bases of the FBT and payroll tax are similar but it is possible to have the ATO agree on an FBT position which is not accepted by States in relation to payroll tax. This creates very significant compliance costs for taxpayers and no benefits in terms of tax policy or administration. Taxes with respect to land (land tax and non-business conveyance duty) would be the taxes which could remain at the State level if a full transfer was not feasible for political or other reasons and such taxes remain in place.

2.5.4 Federal-state financial relations

We consider that the solution to federal financial relations developed when the GST was introduced provides a model of how this difficult issue is best handled in the Australian context, revenue sharing in terms of the different approaches described in the Consultation Paper pages 185-189. Most of the tax revenues arising from efficiency benefits from tax reform accrue to the federal government through the income tax. That does not create the ideal incentive for States to engage in micro-economic reform.

If a unification of administration of (most of) Australian taxes can be achieved through tax reform as suggested above, the Federal/State financial issues can be solved by earmarking the revenue of particular taxes for the States in a way which allows States to participate directly or indirectly in revenue from efficiency gains. These would ideally include taxes which can have discretionary elements (such as rates and certain exemptions) for the States without creating economic distortions or administrative difficulties.

2.6 Certainty and simplicity: tax administration

Simplify tax law by removing unnecessary specific anti-avoidance provisions which create complexity and produce uncertainty, and ensure more consistent and balanced administration of the tax law

In our Initial Submission we put forward two main proposals as regards issues to do with the simplification and administration of tax law:

- the removal of many anti-avoidance rules which make the conduct of relatively simple capital raising transactions very difficult for ABA members, the ATO and investors; and
- consistent and balanced administration of the tax law.

We maintain the views there expressed and note with concern that the situation appears to be getting worse, not better.

2.6.1 Reduction of specific anti-avoidance rules

Our Initial Submission contained a case study of the multiple anti-avoidance rules that have to be dealt with in class rulings for convertible preference shares and the difficulty that many investors will have in understanding and applying the tax position as stated in the rulings. Our submission was that this was the result of too many overlapping anti-avoidance rules and that generally only one general anti-avoidance rule should be potentially applicable in the form of Part IVA (modified if necessary to deal with abolition of other specific anti-avoidance rules but retaining the dominant purpose test).

We recognise that in particular circumstances specific integrity rules may be appropriate but in the policy development process there should be a strong onus on proponents of specific anti-avoidance rules. There should also be a specific on-going process of review of existing anti-avoidance rules to test whether they are necessary in the light of Part IVA. The recommendations of the Ralph Review to similar effect were accepted at the time but have not been implemented. We consider that this is an important item of unfinished business in the tax system.

In addition to the areas identified in our Initial Submission, we note that in recent tax treaties, anti-avoidance rules are multiplying in a way which makes international business particularly difficult. The recent Australia Japan tax treaty has no less than three specific anti-avoidance rules applicable to each of dividends and interest, above the normal OECD Model provisions (see articles 10(10), (11), 11(7), (8), 23 of that treaty).

It is apparent that these rules were inserted at the request of Japan but they apply bilaterally and so can affect Australian taxpayers as well as Japanese taxpayers. They thus will create considerable uncertainty as to when tax treaty benefits will be available. An example of this problem is the decision in Deutsche Asia Pacific Finance Pty Inc v Commissioner of Taxation [2008] FCA 1570 decided in October 2008. The 2001 Australia US Protocol contains a provision inserted at the behest of the US to protect a rule in US domestic law dealing with the borderline between debt and equity. Even though Australia enacted what it considered the appropriate borderline in 2001 and the arrangement concerned was treated as debt under those rules, the treaty rule was relied on by the ATO to treat the return like equity. The effect was to deny a lower cost of funds to an Australian bank and the arrangement had to be unwound at considerable cost. So far as there was a tax cost concerned in the arrangement, it was borne largely by the US, not Australia.

The ready acceptance of anti-avoidance rules for source taxing rights reflected in recent treaties runs counter to Australia adopting a more residence based treaty policy. As the rules largely emanate from the other treaty party, they should be confined in operation to that partner and Australia should rely instead on Part IVA as the means to deal with unacceptable tax avoidance. The ready acceptance of such rules in our view is exactly the wrong direction for Australia to take and one of the sources of our broader concerns in the tax avoidance area.

The policy stance of making Part IVA the main recourse for tax avoidance has particular relevance to the implementation of the taxation of financial arrangements (TOFA) legislation in the near future which has considerable significance for ABA members. Treasury and the ATO have already documented with the private sector many issues of policy and interpretation under the rules. A number of possible specific anti-avoidance rules have been signalled and indeed drafts were released but for the time reliance is going to be placed on Part IVA.

It is very important that any changes of a specific anti-avoidance nature introduced in relation to TOFA have true prospective effect. As financing transactions are often of a long-term nature, to be properly prospective specific anti-avoidance rules (even if made effective from the date of announcement rather than enactment) should only apply to transactions entered into after the relevant date and not to flows of income under existing arrangements after that date. This concern is not limited to TOFA cases.

As noted in the general discussion at the beginning of this submission, this concern is not merely a matter of certainty and simplicity in the operation of the tax law. Significant transactions undertaken by ABA members typically have an international dimension and it is important for international competitiveness reasons that Australia be seen as a country with a balanced approach to tax avoidance and with sufficient certainty for international investors to obtain reliable advice or rulings on the operation of Australia's tax laws.

2.6.2 Consistent and balanced administration of tax law

In our Initial Submission we suggested that the current administration of the tax law is not as consistent and balanced as it should be. Since writing that submission the ATO has issued a number of further rulings which give cause for concern. We have highlighted a number of recent rulings in our discussion of international double taxation above and noted how in our view they are contrary to the policies underlying the measures they are interpreting.

Another area of particular concern has been the anti-avoidance rules in the imputation area and Ruling TR 2008/D8 on "dollar value convertible notes" is an instance of the problem. The transaction in this draft ruling is a variant on an arrangement that the ATO approved in the past but the development of the ruling has been on-going for some time (this is the second draft ruling issued on the issue) and seems to indicate a change in approach by the ATO. We can provide many other instances of such changes of direction which make it very difficult for ABA members to implement funding and other structures which seem to them to fall within positions accepted by the ATO in the past.

Consistency in administration is a very important element in making anti-avoidance rules work with sufficient certainty. We have suggested that in the future the approach should be to rely on one main rule over a period of time. Other things equal, this should have the advantage that as court cases and rulings are given, the details of its operation become clearer.

In contrast, in a law with specific anti-avoidance rules, it is unlikely that either judicial or administrative detailed guidance will emerge even over an extended period. If, however, the approach by the ATO to the rules is not consistent over time both general and specific anti-avoidance rules become unworkable for taxpayers, requiring an approach to the ATO on every major transaction for a ruling, which is not practical given the time-frames and expense involved in obtaining rulings.

Balance is equally as important as consistency. We noted that ruling TR 2006/9 in the interest withholding tax area as a matter of interpretation represents a practical solution to the operation of the rules (our concern is with the underlying policy). It has been the experience of ABA members in recent years that it is impossible to predict whether the ATO will take a practical approach or will proceed on views of the law which are unworkable in practice and which require constant approaches to Treasury to try to get rules fixed which in the view of many private sector parties do not really need fixing if the interpretation of them in the first instance had regard to practical operation of the tax law. Such balance and consistency, like the expression of anti-avoidance rules has an important international competitiveness dimension. Tax risk increases with uncertainty, and if tax risk in Australia is seen as high (because of uncertainty), investors are likely to avoid Australia as a location for investment.

2.6.3 Consider a Board structure for governance of the ATO

Although the examples given above are recent, and ABA members consider that problems are getting more difficult, not better, the underlying concern is not new as is evident from the Ralph Review recommendations. In the ABA's view, this indicates that there are systemic issues involved in achieving consistency and balance in tax administration. For that reason we consider that different structures have to be used to seek to address the issues. Up to now the trend has been to subject the ATO to external reviews of various kinds. While these reviews have achieved particular improvements, in our view a broader cultural change in tax administration is needed to have more regard to underlying policy and greater recognition of business realities. Such a cultural change requires internal processes with the ATO, not more external reviews.

Based on overseas trends, we consider that this change is best achieved by using a board structure for the ATO and having appointments at that level from various groups including the private sector. In the ABA's view the similar experiment with the Board of Taxation in relation to tax policy has been a significant success and should be considered as a model for the ATO. If as discussed above, various State taxes come to be administered by the ATO that should require a consideration of the governance and structural arrangements for the ATO in any event. It would also provide an opportunity to revise tax administration arrangement more broadly.

2.7 International competitiveness, certainty and simplicity: GST

Implement structural reform to the GST treatment financial services. Business to business GST free treatment or extend GST free to all financial supplies.

In our Initial Submission we raised the issue of the GST treatment of financial supplies. Although GST generally is not being considered by the Review, the Consultation Paper pages 142-143 recognised that this is a particular distortion that falls within its terms of reference. We consider that this is a matter that the Review should address further.

2.7.1 Background

Prior to the introduction of the GST in Australia in 2000, the principal indirect tax imposed was the wholesales tax regime. This regime caused a number of distortions and less than ideal outcomes in the Australian economy due to its inconsistent treatment of differing industries.

A GST regime will generally treat all industries in a consistent manner by acting as a tax on final consumption. A GST regime is structured to achieve this by way of the tax credit mechanism that ensures all acquisitions of enterprises before the final consumer receive credit for any GST that they incur. This broad design principle is to ensure that businesses are 'neutral' to the impost of GST.

The introduction of the GST to Australia in 2000 has to a great extent eliminated the type of distortions created by the sales tax regime. However, the exception to this in terms of GST is financial services. In this aspect of GST reform, Australia in 2009 lags behind its trading partners and near neighbours.

2.7.2 Financial Services as an Intermediary

The original design of the VAT/GST regime in Europe looked at this issue and concluded that it was not practical to apply the general principle of neutrality to financial services. It would be too difficult to value the intermediation services that banks provide to impose a GST on that service. The cost of the intermediation service is seen as the spread or margin generated by the banks which is shared by the borrowers and lenders.

Therefore, the position that was adopted in Australia in 2000 was to follow other jurisdictions that implemented a GST regime. There would be no GST charged on the value added by financial service providers but importantly, those providers would not be able to take advantage of the 'rebate' mechanism open to other businesses and would be denied input tax credits on their acquisitions.

The Government Paper, Not a new tax, a new tax system of August 1998 stated:

> *"Some financial services are structured in a way that makes it extremely difficult to subject them to GST. The international experience has been that it is difficult to identify and measure the value added of many financial services on a transaction by transaction basis. However, there is no reason why private consumption of financial services should be tax-free.*
>
> *The Government will input tax some financial services in line with current international practice".*

On this basis, neutrality was not achieved with regard to financial services. To address some of the problems associated with 'input taxation', the Australian GST system did attempt to compensate for some distorting impacts by introducing some 'special rules' to provide banks with access to a limited 'rebate' system.

The Treasury Consultation Document of August 1999 stated:

> *"… many overseas jurisdictions have attempted to ameliorate the problems of input taxation by extending the scope of input taxation 'upstream' to another layer of suppliers. A disadvantage of this approach is that it increases the compliance burden of suppliers to financial institutions.*
>
> *… the Government proposes that the self-supply bias be addressed by allowing reduced input tax credits rather than extending the scope of input taxation. This approach can deliver a similar tax outcome to broader input taxation (ie revenue neutral) but at a lower compliance costs for certain suppliers to financial institutions. The approach also reduces other potential self-supply biases as fewer suppliers are subject to input taxation".*

However, these special rules only apply to a limited number of acquisitions. There are also some interpretive issues associated with these provisions which result in additional complexities and compliance and administrative costs.

In addition to this policy stance, in the ABA's view the financial services sector serves as an intermediary between lending and borrowing. As such from an economic standpoint financial intermediaries provide the means to consumption, rather than actual consumption.

In simple terms, Banks allow customers the means by which they can consume goods, services and other assets. The difficulty from a GST design perspective is that the bank is providing a two – way 'service'. A lender will deposit funds in the bank, the bank effectively provides a service of 'safe keeping' whilst the bank then uses those funds and will pay the lender a 'rental' fee by way of interest – the net value of the two way service is reflected in the interest paid to the depositor. The difficulty is that the retail depositor is not registered for GST and therefore the GST system is not able to capture and tax the value of the two way supply or service.

Furthermore, the design of GST as a tax on final consumption would provide that the GST should only apply on the purchase of goods and services but not on savings. That is, deferred consumption or savings will generate interest which if taxed will result in double taxation as the final consumption will also be taxed when goods and services are purchased from the deferred consumption.

2.7.3 The problem of tax cascades

Hence an embedded GST in the Australian financial sector is effectively a double tax on consumption in two senses. Consumers bear embedded GST on the cost of finance in addition to GST on the underlying goods or services consumed. Where finance is provided to business, the embedded GST on finance forms part of the cost base to which GST is later applied leading to tax cascading or double taxation. Further if financial services are taxed there is a double impost on the deferral of consumption represented by interest as well as the actual deferred consumption itself.

That is, the approach of input taxing or exempting financial services is a distortion on the pure VAT model. In the B2B context as the businesses are not able to recover the embedded GST included in the financial services they acquire it leads ultimately to cascading of GST through the supply chain. This leads to economic inefficiencies such as Australian exports being less competitive when the additional costs of financing are imposed on exporters. Further, with respect to consumers there is double tax apart from the cascading between businesses.

2.7.4 Some responses to input taxation

Recently, there has been considerable discussion of distortions with respect to the finance sector and now a movement away from the traditional approach to input taxation of financial services by way of GST / VAT reform.

The European Community recognised the importance of international competition in its 2006 White Paper on modernising the VAT obligations for financial services and insurances:

> *"VAT should not generate unnecessary obstacles to the achievement of agreed public policy objectives. Market considerations also require that VAT is applied in a manner consistent with a level playing field and accordingly any review of the existing provisions must address the elimination of VAT attributable competitive distortions".*

The EU has been seeking solutions to VAT problems in the finance sector and has sponsored a number of projects to that end. New Zealand and Singapore which are Australia's near neighbours and competitors have both adopted completely new models for the taxation of financial services.

New Zealand

In October 2002, the New Zealand government proposed that from a policy perspective, there was a need to address the effect of tax cascades in GST:

> *"The government considers that, in practical terms, the most serious difficulty with exemption is the over taxation of businesses caused by the inability to recover input tax. Tax cascades are the direct result of this and should, therefore, be the initial focus for reform."*

To address this issue, New Zealand introduced business to business (B2B) zero rating of financial supplies on 1 January 2005. For a supply to be zero rated and hence give rise to an entitlement to input tax credit to the provider of the financial supply, the supplier (such as a bank) must meet three criteria:

- The supply is made by a registered person who has elected to have zero rating treatment apply; this election need not be by a 'bank' but any entity who makes financial supplies.

- The services are supplied to a registered person, that is, zero rating cannot apply to unregistered consumers but only businesses.
- The recipient of the supply must make at least 75% of their total supplies as taxable supplies.

The final element is seen as important as it ensures that the zero rating regime does not extend into entities that are making exempt or input taxed financial supplies. Therefore, inter bank financial supplies will continue to be exempt to ensure that the private consumption of financial services is still taxed.

Singapore

Singapore has used differing mechanisms to New Zealand, but it has still effectively eliminated embedded tax on financial supplies to businesses. The approach that Singapore has adopted is to for 'banks' and 'merchant banks' to apply an 'input tax recovery ratio' for the purposes of allocating input tax between taxable and exempt supplies.

It eliminates the tax cascade by permitting the banks to recover a proportion of their input tax in respect of B2B loans. This is determined on a ratio basis by examining the proportion of B2B loans and offshore loans compared to total loans.

2.7.5 Key benefits of GST Reform

Australia has lagged behind its competitors in terms of GST reform. The approach of Singapore and New Zealand has been to reduce the inherent economic distortions that arise out of a 'traditional' input taxation of financial supplies. In this context, Professor Krever of Monash University's Policy Research Institute, Department of Business Law and Taxation, recently stated in regard to Singapore and New Zealand that:

> *"This approach is ideal from an economic theory perspective as it eliminates any tax distortions and economic inefficiencies, strengthening the economic environment in which New Zealand and Singaporean companies operate. It also gives firms in both jurisdictions a competitive edge over counterparts in Australia".*

The key benefits to Australia of reforming GST treatment of financial supplies are:

- Remove inefficient tax cascading, which creates economic distortions that negatively impact competitiveness of overall economy.
- Reduce compliance costs and complexity for the financial sector.
- Enhance Australia as a financial services hub by improving efficiency.
- Free up the flow of capital, thus improving Australia's ability to attract foreign capital.
- Reduce the costs of providing financial services to businesses and consumers.

- Increase national savings, through the removal of embedded tax on deposits, superannuation etc.

2.7.6 B2B Recommendation

On this basis, the ABA urges that as a minimum, B2B treatment of financial supplies be adopted as key initiative to enhance the efficiency of Australia's financial services sector and improve Australia's international competitiveness. This minor modification to Australia's GST regime will still be consistent with Treasury's overall design principles of the 1998 White Paper.

Whilst specific modelling will need to be undertaken by Treasury, it is thought that the revenue impact of a B2B regime will be modest.

As a further issue, the ABA urges that consideration be given to introducing a complete GST free treatment for financial supplies. This type of reform will go further than a B2B regime by extending the economic benefits of zero rating / GST free treatment to the private consumption of financial services.

Australia needs to move quickly (as did New Zealand and Singapore) to reform the GST regime to reflect the global approach to business operations of the 21st century. There will be political issues to address from the perspective of the various State and Territory governments when it comes to reform of the Commonwealth's GST legislation. These issues will need to be worked on collaboratively to ensure that Australia's GST regime does not repeat the design faults of the previous sales tax regime that lead to sub optimal economic outcomes in the Australian economy.

2.7.7 General zero rating of financial services

The ABA considers that while the B2B proposal would be a considerable improvement to the GST, it would still not address the systemic double taxation of savings that a consumption tax like the GST is designed to avoid. We consider that this is an important issue for national savings and that the correct policy is not to apply the GST to financial intermediation at all. This result can be achieved by zero rating of all financial supplies and the ABA submits that the Review should adopt this approach. It would have the benefits of the B2B approach but to a much greater degree.

Appendix 1: Broad policy framework for tax reform

There are several major policy choices raised in the Consultation Paper in the context of which reference is made to modern economic literature on the topic. The purpose of this Appendix is not to conduct a detailed critical analysis of that literature. Rather, it is to consider the degree to which the literature may represent the firm consensus of economists and policy makers or not, and what the consequences of such judgments are.

Income v consumption

At the individual level, much of the literature in the theoretical vein of optimal taxation has suggested that the greatest efficiency (or least efficiency loss, given that all taxes in the real world involve efficiency costs) can be obtained by a personal consumption tax base with the rate scale constructed as linear, and equity issues taken out of the analysis by cash transfers, e.g. Kaplow, 2008.

This approach has not gone unchallenged. A convenient recent summary of the problems in the literature may be found in Apps & Rees, 2009. Essentially the models used involve various problems: initially at least they merged male and female labour supply; they ignore household production and the necessity this produces to model the household as a small economy; and, they assume that personal consumption can be observed in a way that it can be taxed to the individual who is consuming. In fact like household production, personal consumption cannot be effectively observed and the personal expenditure tax ends up being levied on a household basis, with the same kind of adverse efficiency consequences for labour supply by secondary earners as family unit income taxation.

Much of the literature on expenditure tax equivalents at the business entity level starts with the assumption that taxation at the individual level is on an expenditure base and is seeking a complementary tax at the corporate level, e.g. Meade, 1978. If this is not the case for the reasons given in the previous paragraph, the need to undertake the exercise falls away. If such a tax, or some variant on it such as cash flow taxes, CBIT, or ACE are considered as justifiable in their own right at the business level, it is often on the basis that the income tax cannot reach infra-marginal returns and only taxes the risk free rate of return on investment, e.g. Weisbach 2004a, 2004b, which however should be and is exempted under the alternative taxes.

Apart from the fact that firms do not in reality have the kind of unlimited borrowing and portfolio adjustment capacity that the analysis assumes, the analysis ignores the political economy of the corporate tax (Head, 2009). The income tax levied on corporate income, including the risk free rate of return, is unlikely to produce the kinds of deadweight losses that some of the modern literature suggests and conversely a number of the variants probably do tax the risk related return (Brennan, 2009, Elkins and Hanna 2009, Zelenak 2006). The kinds of large scale shifting of the corporate tax to labour estimated in some recent studies is for similar reasons unlikely to occur.

Accordingly, the case for the different kinds of taxes is very mixed. As the income tax is relatively familiar, much more of a case is required for a significant shift in the tax base at the corporate level. It is sometimes said that the alternatives are much simpler than the income tax. For those which operate with a measure of income as their starting point, such as allowance for corporate equity (**ACE**), this is clearly not the case. For others such as cash flow taxes, the elimination of depreciation and timing rules are said to be significant simplicity advantages, but consideration of the difficulty of defining supply and consideration under the GST would indicate that the claimed simplicity arises by comparing a real world complex existing system with an ideal system that does not operate anywhere. Moreover, all the discussion ignores that the income tax operates off the accounts of the business and any alternative system would have to do likewise. As accounting profit is a closer approximation of income than any of the alternative tax bases, its use for income tax purposes is much more obvious and transparent with an income tax, compared with any alternative tax base.

Further, the Tax Value Method (**TVM**) exercise of 1999-2002 (which was simply to introduce a reformulated calculation of income tax) demonstrates the systemic difficulties that such a large scale replacement exercise would involve. Continuation of the income tax with appropriate maintenance and repair avoids such difficulties, as well as significant transitional gains and losses.

Finally, business people and the community intuitively understand what an income tax is (and what a GST is). The alternative tax bases are so indirect and counterintuitive that they would not be understood by the business or general community. Hence they would have much greater difficulty in attracting the kind of moral support or acceptance on which voluntary compliance depends.

Capital income and tax competition

Another variant of the debates about income and consumption taxes is that capital is highly mobile internationally, and therefore much more difficult to tax, than less mobile factors like land and labour. This in turn leads to a number of propositions – that income from capital is shifted to other factors or that the required rate of return on capital is set by world markets and not by any particular country. Accordingly, it is argued that even if it is appropriate to tax income from capital, tax rates should be lower and flat rate.

While we accept that capital is more mobile than labour and that this has implications for tax policy, we consider that Australia is already addressing such issues (and should continue to do so) without significantly changing the basic structure of the income tax system. The economic literature in this area is highly contested for the kinds of reasons given under the previous heading. The sensible strategy for Australia is to move with the international mainstream so as at least to maintain its relative competitive position in relation to inbound investment.

As the Consultation Paper notes, the major tax that Australia levies on foreign investors is the corporate tax (with taxes in relation to natural resources also being important). Putting aside economic rents associated with natural resources, there are a variety of possible explanations for the relative robustness of the company tax which make it difficult to accept conclusions based on economic models which assume small open economies and completely free flows of capital internationally. Accordingly, a strong conclusion about shifting based on such theories need to be discounted, as do the empirical studies claimed to evidence such shifts, Head, 2009.

In some specific cases it has been clearly demonstrated that tax shifting occurs internationally. The best known example is withholding taxes on interest for which there is a long standing theoretical and empirical literature demonstrating the increase in the cost of debt capital in countries in the presence of cross border flat rate final withholding taxes which have many of the characteristics of tariffs, eg Brean, 1984, Slemrod, Hansen and Procter, 1997. Accordingly, general or targeted removal of interest withholding tax has a significant effect on the cost of debt capital, especially for a country which is very reliant on international debt markets like Australia.

Although Head 2009 is somewhat sceptical about the need for countries to be astute about their competitive position in setting company tax rates, we consider that the recent OECD work (2007a, 2007b, 2008 and note Head and Krever, 2009) in this area suggests that there will continue to be downward pressure on corporate tax rates and that countries do need to consider their competitive position.

For countries with reasonably sized economies, especially where significant natural resources are involved, like Australia, the relatively large economic responses that small economies may be able produce by significantly cutting company tax rates do not exist – the cost in terms of revenue is likely to far exceed national welfare gains. Nonetheless, gradual reductions in the company rate can be expected to continue into the future and Australia should be constantly considering its position on a global and regional basis.

It is now a decade since the last company tax rate reductions was announced in Australia and it is time to revisit this issue. Although it is very difficult to disentangle the business cycle from the process, the OECD studies suggest that countries that gradually reduce rates over time do not suffer competitive disadvantage. It is possible that there may be in fact be modest national economic gains if at least some of the economic efficiency claims for rate reductions are correct. So far as this may produce reductions of tax on economic rents arising from resources, there are other instruments available to deal with them separately.

Moreover the international importance and mobility of financial intermediation means that location of such activities can be very sensitive to taxation. One particular issue that has been of concern in many countries is the tax treatment under VAT/GST of financial services as input taxed. While considerable efforts have been made within the EU to deal with this problem, no general solution of taxing such services under VAT/GST has yet emerged. In that circumstance the expedient of introducing GST-free treatment for business to business transactions at least removes embedded tax off business which has efficiency benefits.

So far as the domestic individual tax base is concerned, Australia has responded to concerns about taxes on income from capital by a variety of measures that are common around the world, including in the areas of housing and retirement income, without generally abandoning the income tax base. As suggested in relation to other areas it is considered that the best strategy for Australia is to monitor international and domestic developments and to introduce targeted initiatives as appropriate. We consider that the obvious disadvantages suffered by deposit accounts compared to other simple investment options need addressing and there is a trend around the world to do so. There are both equity and efficiency benefits of such a targeted measure.

Australia as a base for international business operations

The Consultation Paper raises the possibility of rates of return being set by international markets which leads to questions about the continuing policy justification for imputation. We consider that the international capital market assumption involved here does not currently apply to equity investment, even if it is the case for debt markets.

As noted above, the economic literature does not speak with one voice. While the Australian empirical evidence may be mixed (Board of Taxation, 2007), the strong view of most of corporate Australia is that imputation has a clear impact on the cost of capital of Australian firms and that the economic benefits of eliminating or reducing imputation have not been demonstrated.

In that context, we consider that it is important to address Australian policies for maintaining and improving Australia's tax system in relation to our being a base for international business operations, both for multinational companies' direct investments here and abroad, and for funds management activities. The main policy issue raised is the correct policy benchmark to apply and the implications of the benchmark. At the moment the capital export neutrality (**CEN**) benchmark is applied in the funds management area while the National Neutrality (**NN**) benchmark is applied in the company area. This inevitably created pressures between the two areas for businesses to re-characterise themselves from one to the other (in simple terms to convert from companies to trusts).

The existence of the company tax as the main source tax around the world means that this borderline pressure is inevitable, but the different policies at the moment create an additional pressure. It is possible to have source based company taxes and CEN as the general policy for multinationals which for example is the tax position in general terms in the US, UK, France, Germany and Canada. The use of NN in Australia is out of line with the international trend and makes Australia not a tax friendly location for Australian owned multinationals – multinationals based here at the moment would often be better off being foreign owned which is a perverse economic policy given the economic advantages generally recognised to accrue from locally owned and based multinationals. The same CEN measure should apply for both forms of activity.

State taxation

The ABA has previously provided a detailed analysis of state taxation prepared by Access Economics. We adopt the broad economic policy analysis there for the purposes of this submission which we have summarised in the introduction above.

References:

Apps, P and Rees R 2009, *Public Economics and the Household*, Cambridge University Press, Cambridge

Brennan, T 2009, Certainty and Uncertainty in the Taxation of Risky Returns, paper presented to NYU School of Law Colloquium on Tax Policy, 24 April 2009

Board of Taxation 2007, *Review of the Taxation Treatment of Off-Market Share Buybacks Discussion Paper*, Canberra

Brean D J S 1984, "International Portfolio Capital: The Wedge of the Withholding Tax" National Tax Journal, 37(3), pp. 239-247.

Elkins, D and Hanna, CH 2009, "Taxation of Supernormal Returns", *Tax Lawyer,* 62(1) pp 93-116 Zelenak, L 2006. "The Sometimes-Taxation of the Returns to Risk-Bearing Under a Progressive Income Tax", *SMU Law Review*, 59 pp 879-915

Head J G 2009, "Musgrave on Taxation: Theme and Variations" in Head J G & Krever R E eds, *Tax Reform in the 21st Century* Kluwer, London, forthcoming 2009

Head J G & Krever R E 2009, "Australian Business Tax Reform in Retrospect and Prospect: An Analytical Perspective" in Evans C C & Krever R E eds *Australian Tax Reform in Retrospect and Prospect* Thomson, Sydney, forthcoming 2009

Kaplow, L 2008, *The Theory of Taxation and Public Economics*, Princeton University Press, Princeton

Meade, JE 1978, *The Structure and Reform of Direct Taxation*, George Allen and Unwin, London.

OECD 2007a, *Fundamental Reform of Corporate Income Tax*, Tax Policy Studies No. 16, OECD, Paris

OECD 2007b, *Taxes and Economic Growth: A Progress Report*, Note by the Economics Department and the Centre for Tax Policy and Administration, OECD, Paris

OECD 2008, *Tax effects on Foreign Direct Investment: Recent Evidence and Policy Analysis*, Tax Policy Studies No. 17, OECD, Paris.

Slemrod, J, Hansen, C, Procter, R, 1997, "The Seesaw Principle in International Tax Policy", *Journal of Public Economics*, 65(2) pp 163-176, reprinted in Hines J R (ed), *International Taxation*, Edward Elgar, 2007.

Weisbach, D A 2004a, "The (Non-) Taxation of Risk", *Tax Law Review* 58, pp 1-36.

Weisbach, D A 2004b, "Taxation and Risk-Taking with Multiple Tax Rates", *National Tax Journal* 57(2), pp 229-243.

Appendix 2: Wholesale versus retail funding

The Australian banking industry's over reliance on wholesale funding is unsustainable

(1) Rating Agencies and bank equity analysts are often critical of the Australian banking systems over reliance on wholesale funding (see A2.2 below).

(2) The basis for such over-reliance is the low (comparative) level of funding Australian banks receive from their customers as a proportion of customer loans (see Attachment 1+2).

(3) The rationale for the above is a function of:

(a) the marked deposit disintermediation trend in Australia, which results in tax incentives to allocate funds to non-deposit products;

(b) Australia's persistent current account deficit, which is partly funded by the banking industry; and

(c) Australia's poor savings rate.

(4) Australian banks would prefer higher level of customer deposits as they are considered more "core" (or sticky) than wholesale deposits that typically disappear upon maturity[*]

(5) As witnessed during the global financial crisis, banks incurred reduced access to wholesale funds and their credit spreads widened materially (see Attachment 3).

(6) While no Australian Bank failed as a result of the lack of access to wholesale funding (as was the case in the US, UK, and Iceland etc) Australian banks reacted by:

(a) Rationing Credit (slowdown in customer lending)

(b) Higher credit spreads charged to customers (passing on higher cost of funds to customers), and

(c) Not passing on all the RBA rate cuts

(7) Australian banks are now reacting to the global financial crisis by enhancing their liquidity policies and profiles by requiring greater levels of customer deposits to fund Australian customer lending ie reducing reliance on wholesale funding.

[*] Note that bank Group Treasury units undertake analysis as to the "core" (or sticky) nature of customer deposits. On a portfolio basis customer deposits are typically in the range of 60-90% "core" (Institutional deposits are less core in nature than retail deposits).

(8) A major concern for the banks implementing such an enhanced liquidity management discipline is the risk that credit rationing and higher credit spreads will continue unless there is greater percentage growth in customer deposits than demand for customer loans.

(9) Should the above eventuate there would be significant implications on the economy eg lower GDP, lower company profits, higher unemployment, lower government tax collection etc.

(10) Accordingly, a way to reduce the level of credit rationing and higher credit spreads is to remove IWT that would permit deposits made into offshore branches to be swapped back into A$ to fund Australian loans.

(11) In the interim banks will be required to raise increasing levels of term funding in the capital markets to address the customer funding shortfall. The difference in the cost between customer funding and term (5 year) capital market funding is currently in the vicinity of 130bp per annum.

(12) Banks would seek to pass this higher funding cost onto its customer base resulting in similar economic implications as listed in 8 above.

Rating Agencies and Equity Analysts are now focusing on Australian banks increasing reliance on Wholesale Funding

Rating Agencies are highlighting Australian banks reliance on Wholesale (Capital Markets) Funding.

(1) "Another factor moderating the rating is the limited opportunity for retail funding growth across the industry which heightens Westpac's reliance on wholesale funding markets." (S+P December 07).

(2) "A key risk factor moderating the rating is ANZ's reliance on wholesale funding, which can negatively affect earnings and liquidity, given the current volatility in global financial markets." (S+P May 08).

(3) "NAB ….. is increasingly dependent on wholesale funding." (S+P March 08)

Bank Equity Analysts are also focusing on Australian banks need to ration credit because of over reliance on wholesale funding[*]

(1) "With the potential for A$40b each of debt refinancing in FY09 and no easing in the funding environment, we believe the major banks will have little choice but to constrain lending growth".

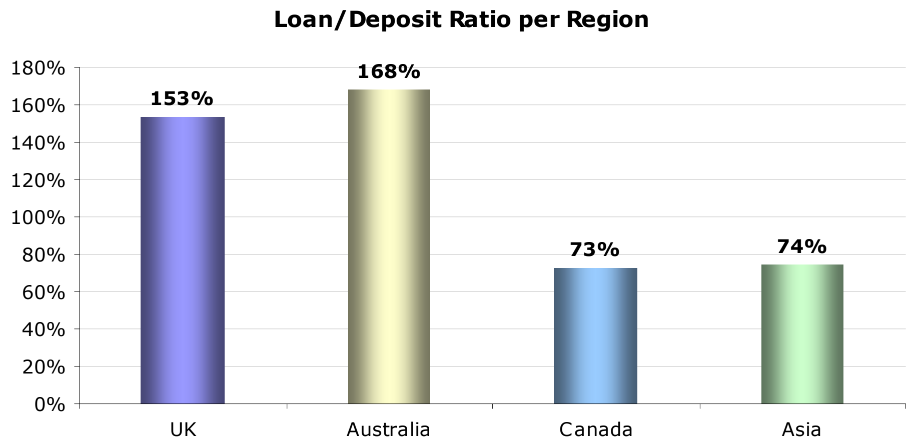
[*] ABN AMRO Equities Australia Ltd March 2008

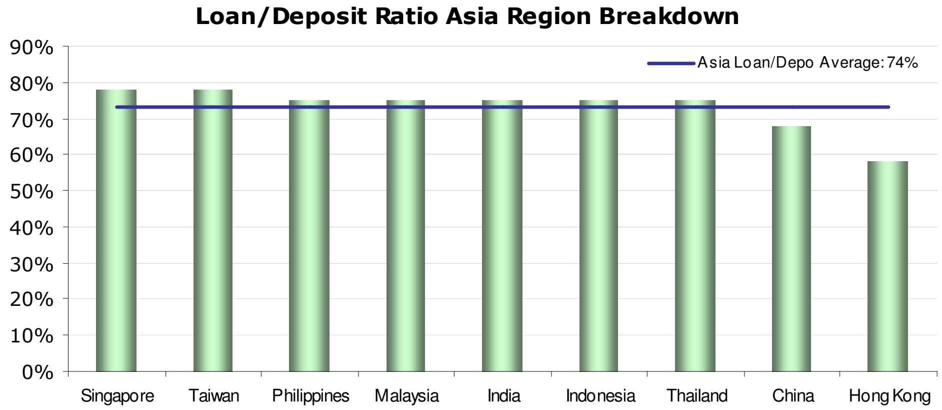
(2) "We expect a pull back in corporate and institutional lending given the pressure the increased funding requirement will likely have on cost and the ability to generate an appropriate economic return on the lending when priced at the marginal cost of funds".

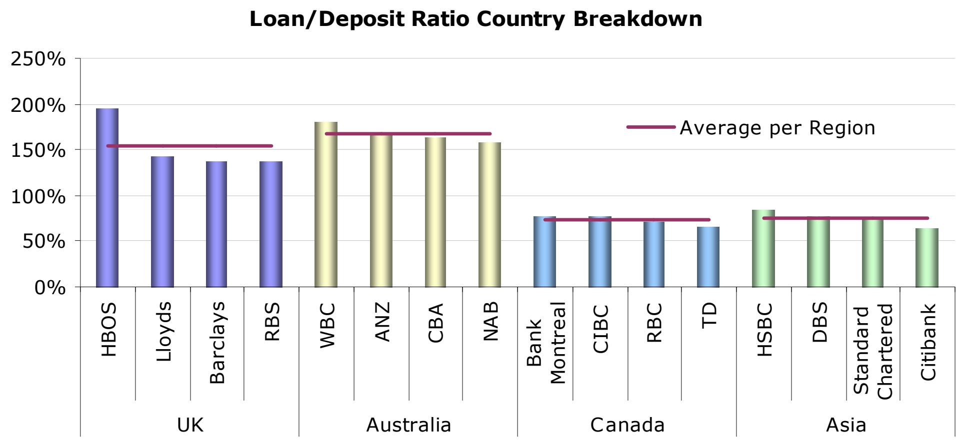
(3) "The impact of a prolonged liquidity crunch, in our view, could constrain lending growth and therefore economic growth, which ultimately leads to further bad debts".

The removal of WHT would permit Australian Banks to increase the level of customer deposits thereby reducing reliance on wholesale funding.

Driven by high household savings rates and current account surpluses Asian banks are substantially more customer deposit funded that Australian Bank

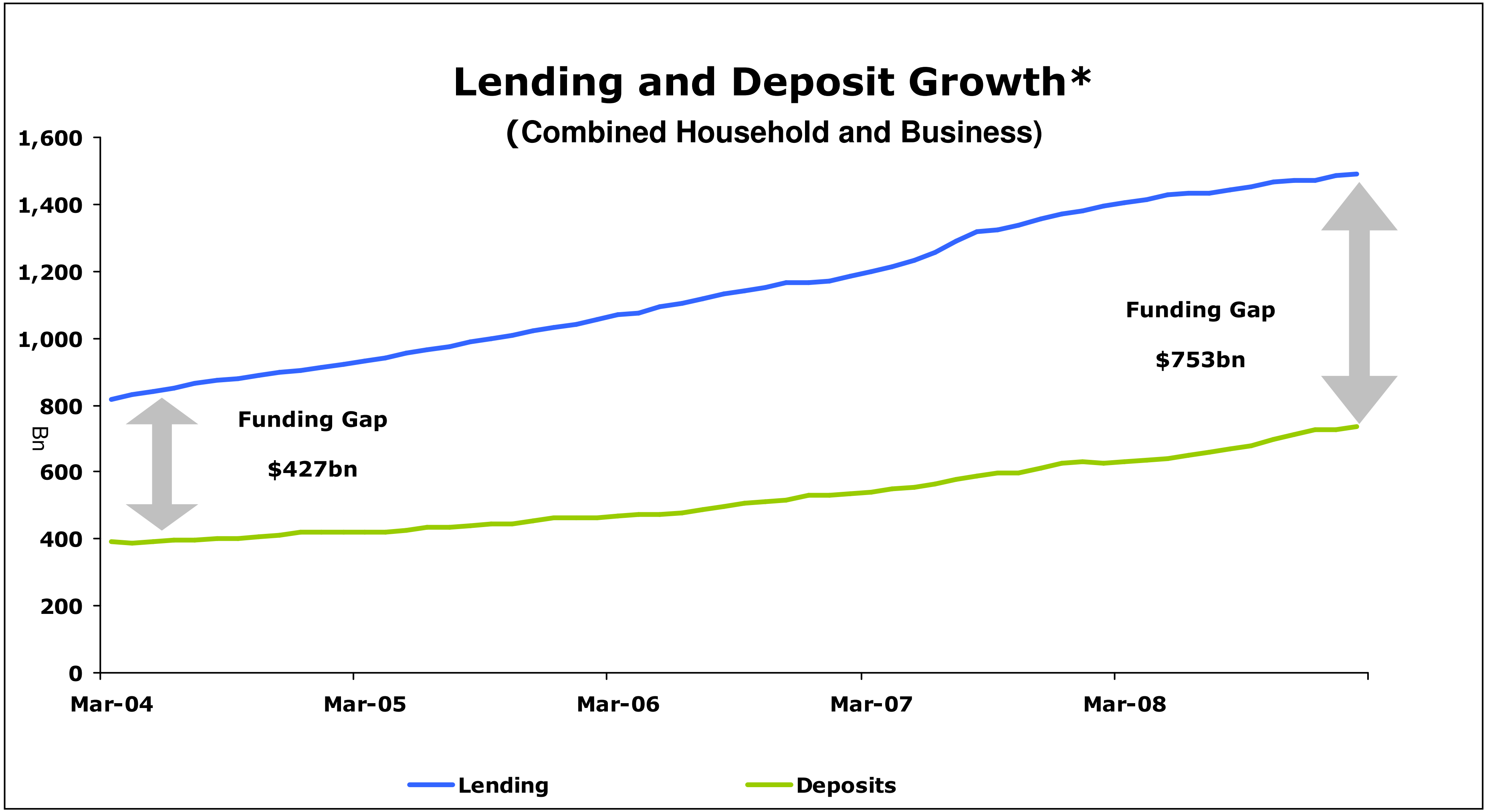






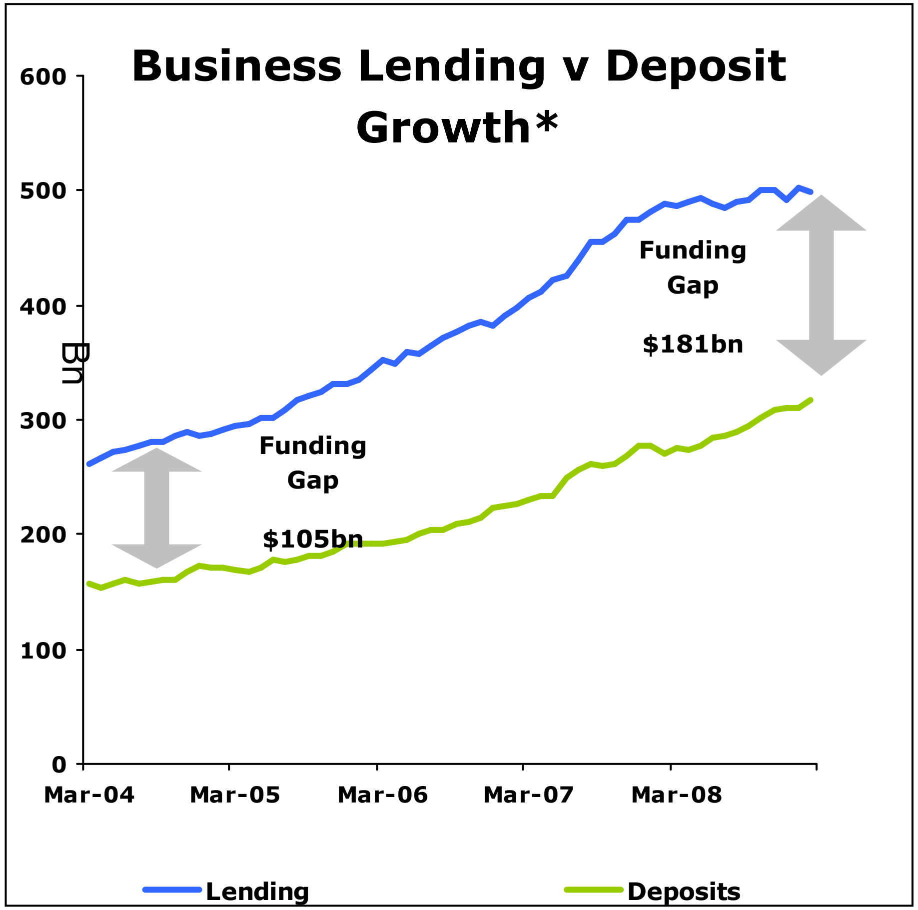
Loan/Deposit Ratio=Total Customer Loans & Advances/Total Customer Deposits

APRA statistics show the Australian Banking "Funding Gap" has increased by A$326b (76%) to A$753b over the last 5 years

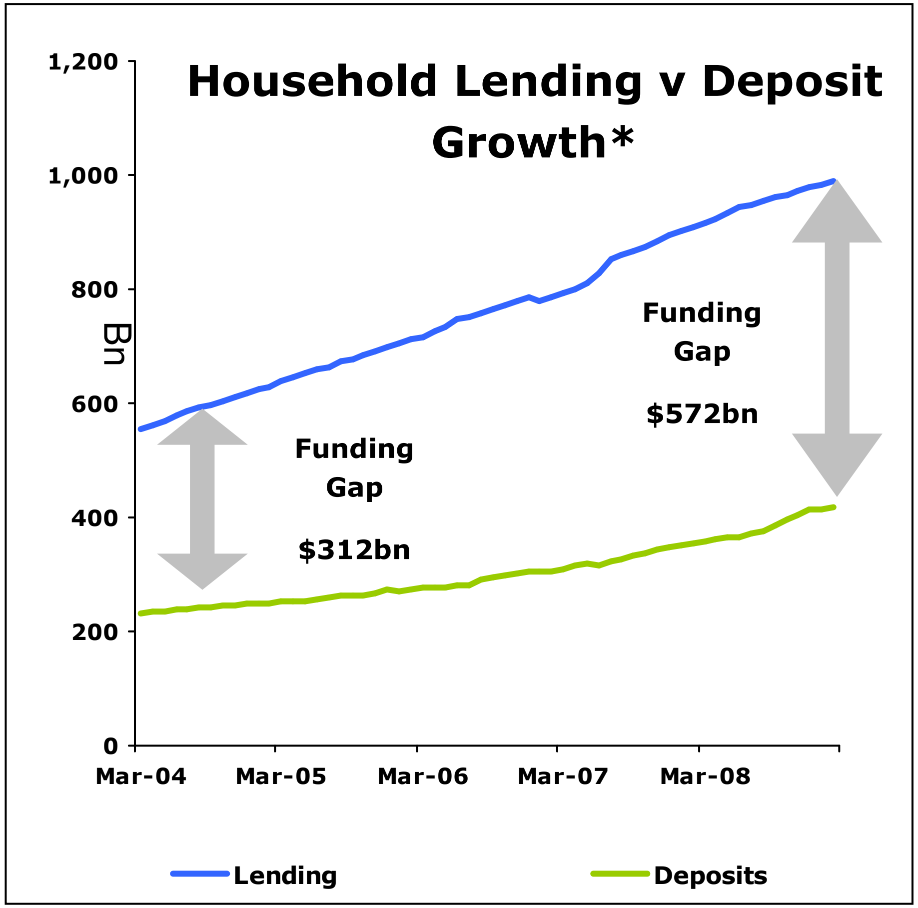


** Lending does not include lending to financial institutions, government or non-profit institutions. Deposits do not include deposits by financial institutions, government or non-profit institutions. Certificates of deposit not included.*

With the Household sector being the primary driver of the increase

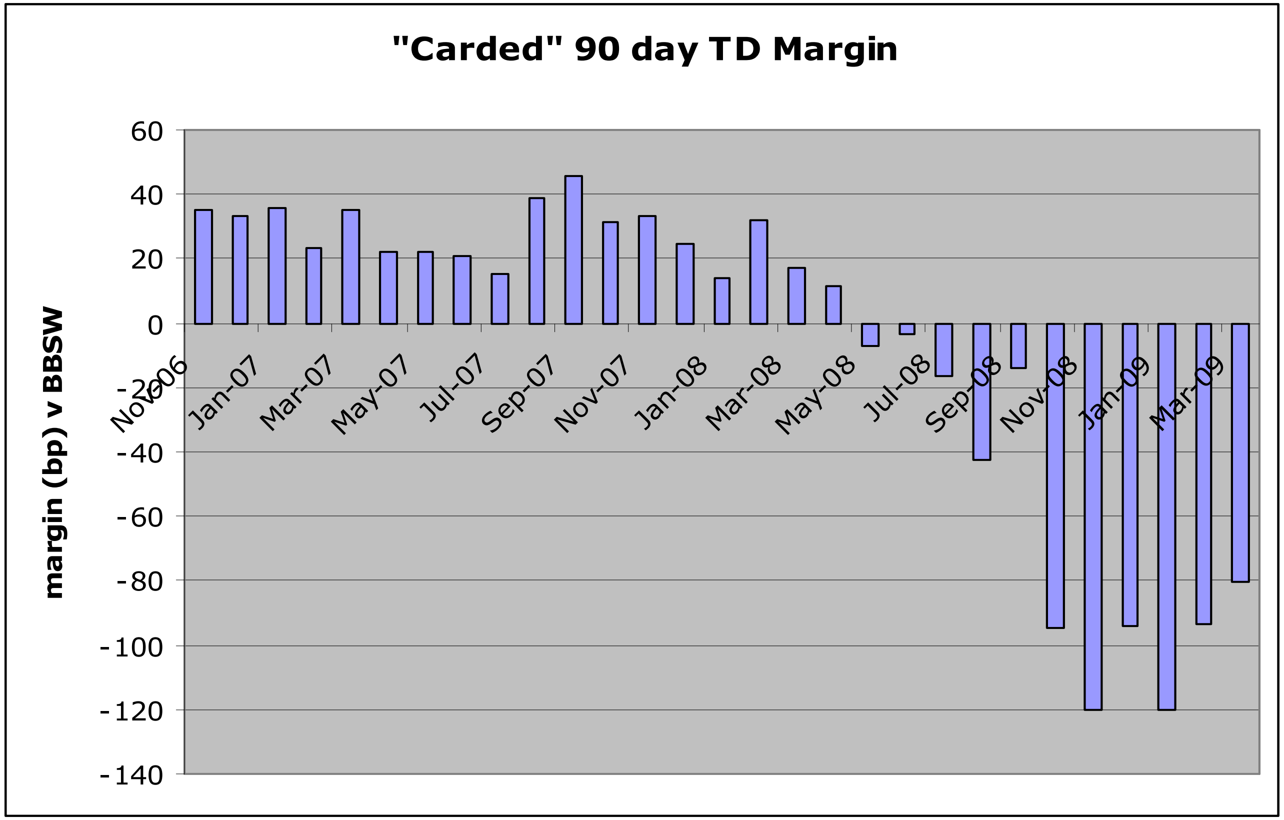


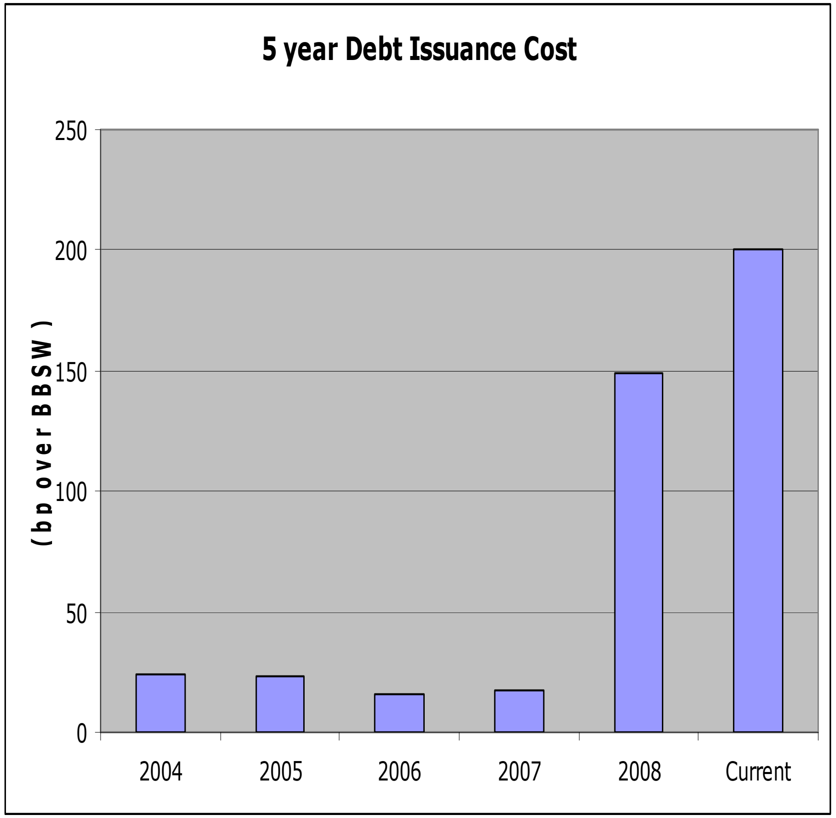
** Business Lending includes lending to non-financial corporations and acceptances by customers. Business Deposits relate to non-financial business deposits.*



** Household Lending includes housing, cards and personal lending and securitised housing loans.*

Improving liquidity profiles is coming at an increasing cost





Removing WHT would reduce the reliance on such expensive forms of funding

Appendix 3: Interest withholding tax collections

Australian interest withholding tax remittances (2007/08 year)

Representative data from ABA members* ($m)

Type of business	Bank A	Bank B	Bank C	Bank D	Bank E	Bank F	Bank G	Totals (7 banks)
Retail	20.3	NA	Imm	NA	31.3	Imm	0.1	51.7
Wholesale/Corporate/Institutional	3.2	NA	Imm	NA	Imm	Imm	2.3	5.5
Nominee/Custodian	Imm	NA	Imm	NA	Imm	Imm	Imm	-
Overall (not able to be split)	NA	80.0	NA	17.0	NA	NA	NA	97.0
Totals	**23.5**	**80.0**	**-**	**17.0**	**31.3**	**-**	**2.4**	**154.2**

* Includes all four major banks

NA = Not applicable

Imm = Nil or immaterial amount

Appendix 4: Intangibles and black hole expenditure

"Black holes" and Intangibles Representative data from ABA members* ($m)																
Type of new expenditure on …	**Bank A**		**Bank B**		**Bank C**		**Bank D**		**Bank E**		**Bank F**		**Bank G**		**Totals**	
	07	**08**	**07**	**08**	**07**	**08**	**07**	**08**	**07**	**08**	**07**	**08**	**07**	**08**	**07**	**08**
Capital costs deductible but only on a 5 year basis (per s.40-880)	2	30	-	-	7	10	-	50	12	42	1	3	1	1	23	136
Capital costs not deductible at all ("black holes") not including intangibles[1]	-	17	-	-	-	-	-	-	2	2	-	-	-	-	2	19
Goodwill that generates no tax write-offs at all	-	14	7,484	-	5,125	-	2,500	-	208	-	24	465	-	-	15,341	479
Intangibles other than goodwill that generate no tax write-offs at all[2]	-	19	774	672	110	258	-	-	61	1	7	60	1	1	953	1,011
Totals	**2**	**80**	**8,258**	**672**	**5,242**	**268**	**2,500**	**50**	**283**	**45**	**32**	**528**	**2**	**2**	**16,319**	**1,645**

* Includes all four major banks

[1] Includes costs of capital used offshore

[2] Includes:

- Credit card customer value
- Computer software
- Management fee rights
- Customer contracts/relationships
- Distribution channel costs
- Brands

Appendix 5: Recent equity issues

Foreign shareholdings in Australian based banks

Representative data from ABA members

	Percentage of bank's ordinary shares held by non-residents 12 months	Percentage of new ordinary shares over last 12 months sourced from non-residents
Bank 1	22%	20%
Bank 2	33%	20%
Bank 3	25%	15%
Bank 4	10%	10%
Average	**22.5%**	**16.3%**