Re:think

Westpac's Response to the Australian Government's Tax Discussion Paper

1 June 2015

Westpac GROUP

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About Westpac

The Westpac Group (Westpac) is one of the four major banking organisations in Australia.

Westpac was the first bank established in Australia and has grown, adapted, and strengthened to become Australia's second largest bank.

Westpac provides consumer, business and institutional banking services, wealth management, wealth administration and insurance services to customers across Australia, New Zealand and the Asia-Pacific region.

As at 30 September 2014, Westpac had approximately:

- 12.8 million customers;
- 36,000 employees, across the Group's brands and countries of operation; and
- 580,000 shareholders, made up of individuals and Australian and overseas institutions.

Westpac is a significant tax paying company and major contributor in the collection and remittance of various federal and state taxes. In 2014, we recognised over $3 billion in corporate income tax representing a statutory effective tax rate of 29.0%. We collected and remitted in excess of $1bn in GST payments and $182 million in payroll taxes.

Westpac is predominantly owned by Australian investors. As at 31 March 2015, approximately 77% of Westpac shareholders are domestic-based with the remainder being foreign-based. Institutional shareholders comprise 52% of shareholders with 48% being retail investors.

Executive Summary

Westpac welcomes the opportunity to comment on how the current tax system is operating and to provide suggestions on how Australia's tax system can be improved.

This submission provides our views on a limited range of the questions raised, being specific tax considerations which are of particular importance to Westpac, its shareholders and customers. These include the taxation of savings, superannuation tax arrangements, dividend imputation and corporate tax rate as well as the interaction of state taxes and the GST.

The submission comprises five chapters with our observations summarised below.

1. *Consider harmonising the tax arrangements for bank savings with other investment options*

We believe that a move to harmonise the tax arrangements across different savings options is worthy of further investigation. Harmonisation could improve overall fairness and enhance the quality of Australia's national savings pool and improve retirement incomes.

Whilst we strongly support the need for the tax arrangements to neutralise the effects of inflation on asset prices, so that only real increases in income are taxed, there may be a case to consider adjusting the existing capital gains tax ('CGT') arrangements. Aligning the tax treatment and outcomes across savings and investment options would help reduce the influence of tax outcomes on savings and investment decisions and improve overall fairness of tax outcomes for investors at different marginal tax rates. We agree with the Discussion Paper that negative gearing does not, of itself, cause a tax distortion. Investors in property and/or shares typically exhibit rational behaviours when making investment decisions and take into account many commercial factors including their appetite for gearing and the associated after tax outcome.

Our observations reflect a key concern that current taxation arrangements distort the allocation of savings and investments. Australia, as a current account deficit nation, needs a taxation system that encourages investment in productive assets that potentially generate export earnings that will help to alleviate the pressure on foreign liabilities – not the reverse.

2. *Existing superannuation tax arrangements across the accumulation and retirement phases should be retained*

We believe that the tax system plays a pivotal role in supporting the overall objective of providing Australian's with a level of retirement income that either replaces or supplements the Age Pension. In our view, different tax arrangements should apply to the retirement income system than other forms of savings and investments.

Whilst we have made some suggestions for areas where the current system could be enhanced, we are of view that the existing tax arrangements across the accumulation and retirement phases should be retained.

3. A reduction to the corporate tax rate, over time

Australia's reliance on corporate tax revenue is comparatively higher than the OCED average. In addition, our corporate tax rate remains above many OECD countries and some countries in our region, such as China and Singapore.

In our view, continuing to rely heavily on corporate income tax revenue is not sustainable, particularly in the context of a global and increasingly digital economy. In combination with a comparatively high corporate tax rate, ongoing dependency on corporate income tax is not efficient and can lead to lower economic growth and an erosion of living standards.

A reduction to the corporate tax rate, over time, combined with a broad shift towards more efficient indirect taxes is likely to provide long term stability and deliver improved living standards[1].

4. Maintain dividend imputation

The dividend imputation system continues to serve Australia's interests in a number of ways and should be retained. The system eliminates double tax and encourages Australian companies to pay tax. Dividend imputation has deepened the pool of capital available for investment and contributed to lowering the cost of equity as compared to debt. In our view, abolishing dividend imputation could lead to adverse impacts on retiree earnings and materially impact on share prices of Australian listed entities.

5. Imposing additional levies or taxes on financial services only serve to increase the cost of financial services

We do not support the imposition of additional levies or taxes on financial transactions. These only serve to increase the cost of financial services and place Australia at a competitive disadvantage compared to other financial centres.

In conclusion, whilst we have outlined potential options throughout our submission, we have not provided detailed design recommendations nor undertaken extensive modelling on the impacts on Government finances and distributional implications.

We would be happy to provide further information on any aspect of our submission.

[1] Australia's Future Tax System Review ('Henry Review'), Volume 1, page 152

Chapter 1 – Savings

Summary

As noted in the Discussion Paper, Australia currently taxes savings differently depending on the form of the saving.

In this section, we cover the tax arrangements for interest income, capital gains tax and negative gearing. In our view, there is a case for harmonisation of the tax arrangements across different investment options. In particular, harmonisation could improve overall fairness and improve the stability of investment funds and retirement incomes.

Specifically, these tax arrangements should support the role of bank deposits and debt instruments in providing the Australian economy with a high quality and stable funding base and supporting retirement incomes.

Response Questions

18 What tax arrangements should apply to bank accounts and debt instruments held by individuals?

Westpac's view

Bank deposits and debt instruments provide a high quality and stable funding base for the economy, and also represent an important investment for retirees. As highlighted in the Discussion Paper, these forms of investment are currently subject to a significantly higher tax than other types of savings, in particular investment in residential property and equities.

To maintain and enhance this funding source, and encourage growth and investment in interest earning products, we believe there is a strong case for harmonising the tax treatment across all forms of savings.

We note that the Henry Review proposed a 40% income discount for individual and non-business related savings. In our view, this seems an appropriate discount and would contribute to reducing the tax bias of choosing one form of savings over another.

Although the Discussion Paper observes that empirical evidence suggesting the behavioural response to taxing savings is uncertain and may not be significant[2], it may be that low income individuals will lift their savings in response to less onerous taxation. To the extent that higher taxation of savings reduces domestic savings then there are potential implications, namely, the need to access additional foreign savings to supplement domestic savings.

[2] Re:think, Tax Discussion Paper, Australian Government, March 2015, page 59

By itself, a discount on interest income should not lead to arbitrage opportunities but this will also depend on the level of discount available across other savings and investment options.

We also note that Henry advocated extending this discount to investment income generally with a corresponding impact on interest deductions. However, as noted later in this submission, we believe that a study of the impact of tax arrangements on housing affordability and the rental market would help to inform further consideration of this issue.

Supporting Arguments

Aligning tax treatment of savings income with other forms of savings will provide the following benefits.

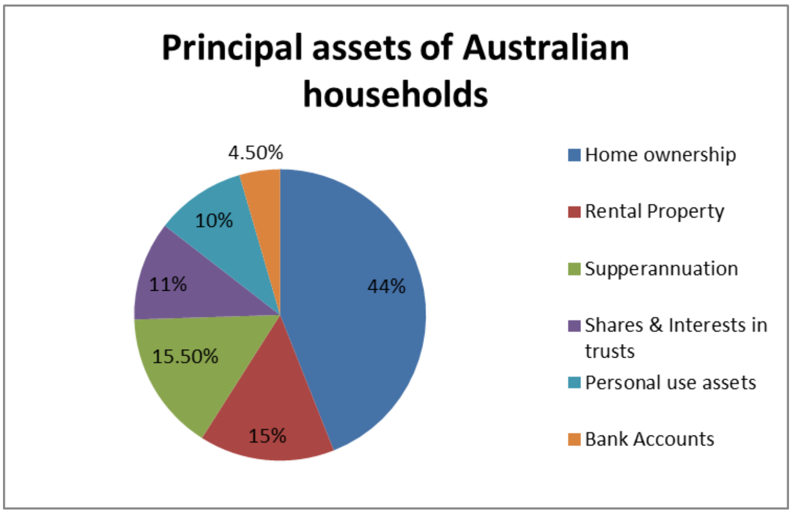
It provides Australia with a high quality funding source to support optimum investment and economic growth

The availability of reliable and reasonably priced debt funding and equity capital is vital for any market based economy, and economic growth.

Without such cash flow, there can be no investment, no new jobs and no economic prosperity. The financial sector's access to funding and capital allows it to fulfil its role as financial intermediary for the business sector, consumers and governments.

Australia's Savings Pattern

Although Australia has a large pool of savings a significant amount is invested outside both the banking system and debt markets. The reason for this probably reflects the different taxation treatment applying to various forms of saving. For example, dividend imputation increases the relative attractiveness of equity investments and Australia's compulsory superannuation system directs a high proportion of savings into superannuation funds. The growth orientation of superannuation means that our system favours a greater allocation of super savings to equities. Some proportion also goes overseas. According to the Australian Bureau of Statistics, the principal assets of Australian households (for 2011-2012) are as follows[3]:



[3] Australia Bureau of Statistics for 2011-2012, Household Wealth and Wealth Distribution, Australia

The impact of these structural issues is that:

- there is less direct savings by households into bank deposits; and
- as a result, there is more wholesale funding on Australian bank balance sheets.

The allocation of Australia's savings pool has implications for how the economy is funded and may create supply constraints in periods of medium to high growth.

How the System Solves for Growth

A high growth outlook in Australia would require, and be supported by, higher credit growth and bank lending. But in some probable economic scenarios, higher credit growth and bank lending in our system may not be possible, and a gap between credit demand and higher quality bank funding could be created.

This is evident from PricewaterhouseCoopers (PwCs) Report "Sustainably funding Australia's prosperity", December 2013, annexed to ABA Submission to the Financial System Inquiry.

In that report, PwC noted that the Government has targeted a return to trend level economic growth, which will need to be supported by a corresponding increase in credit growth. PwC argues that the level of credit demand will differ from that needed during the recent phase of high level resource investment, and that much of this credit demand will most efficiently be sourced through the banking system.

In cases of medium (8%) to high (12%) credit growth scenarios, the Australian banking system will face a substantial funding task to meet demand for credit. The magnitude of the funding imbalance (difference between bank lending and bank deposits) in these scenarios increases to approximately $963 billion and $1,325 billion, respectively[4].

A potential solution to this funding gap is for banks to increase their offshore wholesale borrowings. However, prudent bank management may seek to limit their exposure to offshore wholesale borrowings. Just because investors are prepared to buy Australian bank bonds today, does not guarantee they will do so in the future.

A more likely impact is that banks would increase deposit rates as they compete for more stable, high quality funding to satisfy lending opportunities. This higher demand and higher deposit funding costs would then likely flow into increases in lending rates.

This has the potential to adversely impact those sectors of the economy that primarily rely on bank credit, including individuals, small and medium enterprises and corporates that are unable to access market based funding. These sectors mainly obtain their debt funding from banks and other financial institutions, as it is difficult and costly for them to raise funds directly from debt capital markets[5]. They are likely to pay more for their loans than they would have otherwise. These sectors are very important for Australia's growth in the future.

[4] PricewaterhouseCoopers (PwCs) Report "Sustainably funding Australia's prosperity", December 2013
[5] For small business – see RBA, Submission to the Financial System Inquiry, March 2014, p.124. [Also, the significant number of businesses reliant on bank funding is illustrated by the number of Westpac business customers that have facilities under $100m (a fair proxy for businesses that are likely to find access to market-based funding challenging). As at June 2014, there are approximately 420,000 of those business customers, with total of approximately $125bn of loans which make up approximately 92% of Westpac's total business loans.]

The importance of small business to economic growth was recently recognised by the Australian Government in its 2015-16 Budget, where it referred to Australian small business as the engine room of our economy and recognised that small business is at the forefront of Australia's jobs and growth.[6]

The Government also announced in the 2015-16 Budget that it forecasts trend level growth in 2016-17. The combination of these factors highlights the ongoing importance of promoting an adequate reasonably priced pool of bank funding.

More Efficient Ways for the System to Solve for Growth

Westpac believes that a more sustainable way of ensuring the system can best support growth in periods of higher credit demand is to increase the source of high quality bank funding to support lending[7]. Banks with more, higher quality deposits will have more funds available for intermediation (and, in turn, to support economic growth).

In Westpac's view, the primary long-term solutions for increasing the sources of higher quality funding are:

- equalising the tax treatment between bank deposits and debt instruments with other competing savings options; and
- encouraging the investment of superannuation funds in bank deposits and fixed income securities.

An increase in the source of high quality funding to the banking system means that Australian Banks have the capacity to lend to small and medium enterprises, at a reasonable cost, to foster increases in productivity, innovation, employment and wages.

Tax Equalisation of Bank Deposits and Debt Instruments

Taxation plays a significant role in savings decisions. The Henry Review noted:

'There is considerable evidence that tax differences have large effects on which assets household's savings are invested in. Based on an examination of the literature and OECD data, the OECD concluded that while low-income individuals respond to tax incentives with more savings, for high-income individuals in particular savings are diverted from taxable to tax-preferred savings (OECD 2007)'[8].

Summary

In summary, encouraging investments in bank deposits and other debt instruments:

- will likely reduce Australia's reliance on offshore wholesale funding – which is more volatile and unreliable, particularly in times of stress;

[6] Budget 2015, Growing Jobs and Small Business, page 2.
[7] The fact that deposits provide a higher more stable form of funding has been outlined in various submissions to the Financial System Inquiry, including Westpac's submissions of March 2014 and August 2014.
[8] The Henry Review, Part Two, volume 1, chapter A1, A1-3, page 68, Taxation of income from savings. Reference is to the OECD Report Encouraging Savings through Tax-Preferred Accounts, No.15, 2007.

- will provide a higher quality more sustainable funding base – which is also acknowledged by the regulators[9]; and
- should encourage higher levels of national savings to support economic growth.

We believe that providing an appropriate level of harmonisation of tax relief for bank deposits and debt instruments with other forms of savings will at least lead to a greater allocation of savings in bank deposits. For example, it may encourage investors to redirect some excess superannuation contributions to this form of savings and will also provide a more stable source of retirement income.

Response Question

19	**To what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?**

Westpac's view

The current CGT discount was introduced in 1999 and allows individuals to discount a realised capital gain by 50 per cent provided they have held the asset for 12 months. Superannuation funds are also able to claim a discount of 33.3 per cent.

Prior to the introduction of the CGT discount, indexation and averaging applied to capital gains meaning that only real gains were subject to tax.

We note the concern that the current 50% discount after only 1 year is not appropriate as it does not strike the right balance between removing the impacts of inflation, while discouraging speculative 'asset flipping' behaviour. We believe it is appropriate that the tax arrangements for long term savings neutralise the effects of inflation on asset prices, so that only real increases in income are taxed. However, we recommend considering an adjustment to the current arrangements for capital gains to align the tax treatment with other savings options.

This would support the goal that investment decisions are not taken on the basis of after tax outcomes and would improve overall equity between investors at differential marginal tax rates. It may also moderate the concentration of debt-funded risk-taking in property investment.

We note that if the Henry recommendation for harmonisation (or some variation thereof) was adopted there would be a reduction in the present CGT discount rate. If that was to occur, we would advocate that existing assets be grandfathered. Whilst this would add some complexity, it is appropriate on the basis of treating taxpayers fairly.

[9] APRA has introduced a new Liquidity Coverage Ratio (LCR), which require banks to hold increased levels of liquids assets to meet a 30 day liquidity stress scenario. Under these rules, there is a clear distinction between different types of deposits, and how much a bank can lend from them. The best type is retail, which will allow a bank to use 95% of the value for lending to customers. The least valuable is short term from other financial institutions, which will not allow any lending.

Response Question

21	**Do the CGT and negative gearing influence savings and investment decisions, and if so, how?**

Westpac's view

We note that the Tax Discussion Paper focuses on the impact of negative gearing on housing investment. However, negative gearing is not unique to the property market as investors in shares and most businesses in Australia are also able to access negative gearing.

We agree with the observations in the Tax Discussion Paper that negative gearing, in itself, does not cause a tax distortion. However, it is important to note that negative gearing does have an impact as leverage allows more people to enter the (housing) market. Although the tax treatment of rent, property expenses and capital gains are important considerations, there are other, potentially more significant drivers behind people's decisions to invest in the property market. The major one being capital growth.

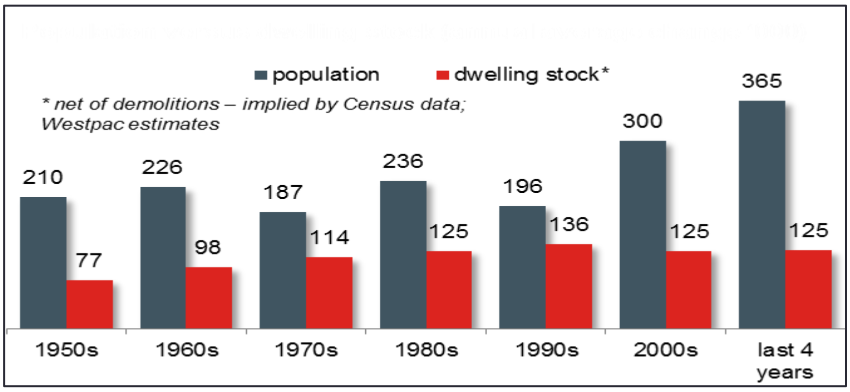
In our experience, investors exhibit certain rational behaviours meaning they take account of a range of factors, both tax and non-tax related. To illustrate, our experience shows that investors prefer a lower Loan to Valuation Ratio (LVR) at origination than owner-occupiers[10], and are sensitive to upfront costs such as lenders mortgage insurance. Gearing is therefore kept at reasonable levels notwithstanding the potential for a larger negative gearing benefit. Investors typically avail themselves of deposit offset accounts and investor repayment behaviour is comparatively strong thus reducing the investor's negative gearing benefit.

In summary, investors are generally not geared to the maximum extent possible for the purpose of maximising their tax benefit.

Although it is difficult to accurately identify the proportion of investors that are negatively vs positively geared, we estimate average LVR levels to be in the range of 45%-55%[11] and this indicates to us that the a significant number of investors' property assets are moving away from being negatively geared.

Property is also seen as an attractive investment in Australia[12]. Another potential factor underpinning investor activity is the impact on values (and therefore capital growth) created through scarcity. Significant demand for housing stock is being driven by national population growth (see graph below[13]) consistently exceeding new dwelling approvals, particularly over the last decade.

[10] Westpac Group First Half 2015 Presentation & Investor Discussion Pack, page 80
[11] Ibid
[12] Westpac Economic Research (May 2015) currently indicates property is second wisest place to save.
[13] Source: REA and Westpac



Source: REA and Westpac

We are not aware of any authoritative literature validating the effect of any proposed change to limit or abolish negative gearing and, to that end, further modelling and analysis is required. We note that the Senate Committee report on Housing Affordability[14] recommended the Treasury carry out a study of the influence of negative gearing and the CGT discount on housing affordability and consequent impacts on the rental market. We agree that such a study would help to inform further consideration of this issue.

As we have noted elsewhere in our submission, retaining the CGT concession together with harmonised tax treatment across other forms of savings and investment options would ameliorate concerns as to the influence of tax concessions on investor decisions.

[14] Recommendation13. "Out of reach? The Australian housing affordability challenge" The Senate Economics References Committee Commonwealth of Australia, May 2015

Chapter 2 – Superannuation

Introduction

The tax arrangements for superannuation should support the overall objective of providing Australians with a level of retirement income that either replaces or supplements the Age Pension.

We believe superannuation tax arrangements need to always be tested against an objective that the superannuation system should aim to deliver up to 65-70% of income replacement in retirement for all Australians.

We do not support increasing taxes in the accumulation phase, such as a higher contributions tax, as this reduces future retirement benefits.

We also believe that the tax arrangements in the retirement phase should be retained, apart from potential changes to accounts with balances in excess of $2.5 million.[15]

Response Question

22	**How appropriate are the tax arrangements for superannuation in terms of fairness and complexity? How could they be improved?**

Westpac's view

The rationale for considering the superannuation tax arrangements independent of other changes to the tax framework reflects the unique characteristics of Australia's superannuation system including:

- the mandatory contribution framework;
- age-based preservation rules which defer access;
- the interrelationship with the Age Pension ; and
- the need to ensure the adequacy of retirement incomes.

Maintaining specific tax arrangements for superannuation savings provides necessary flexibility to address specific concerns around fairness and complexity. Ensuring stable and sustainable tax arrangements boosts consumer confidence in the superannuation system.

Tax proposals and changes that reduce tax benefits will impact on the adequacy of retirement incomes and lead to overall lower retirement balances. Inadequate incomes and reduced retirement balances will mean that the cost of the Age Pension will be higher and retirees spending power will be lower.

[15] The Association of Superannuation Funds of Australia Limited (ASFA), *Superannuation and High Balances,* April 2015,

Accumulation phase – maintain current tax settings

In our view, the current tax arrangements applying to the contribution and earnings stages are appropriate and should be retained.

The embedded concessional tax rate framework is relatively simple to administer and also provides certainty in the context of overall government revenues. The Low Income Super Contribution for low income earners and the Division 293 additional tax for high income earners makes this arrangement broadly equitable and should be maintained.

To encourage further savings, contributions caps should be reviewed to allow workers who are underfunded for their retirement to make additional voluntary contributions to catch up and improve their adequacy. This would include:

- those with broken work patterns (such as parents who have taken time out of the workplace to raise children);
- migrants, who have immigrated to Australia part way through their working lives; and
- workers who have had involuntary periods of non-employment for example due to a redundancy or ill health.

The current annual fixed dollar cap system does not allow the flexibility for underfunded workers to catch up. Government should consider a more flexible arrangement which allows higher contributions where workers are underfunded and have capacity to make greater contributions. We believe the introduction of new integrity measures to limit the amount of assets that can be moved into the pension phase would allow government to increase contributions caps while maintaining the integrity of the system.

Accumulation phase – encourage additional voluntary savings

Under current settings, the majority of Australians who make contributions under the compulsory superannuation regime, currently set at 9.5%, will only ever supplement the Age Pension. For it to be fully substituted, additional voluntary contributions must continue to be encouraged. This is especially the case given the expected increase in life expectancies of the Australian population – currently the fourth longest-lived population in the world.

Many current projections of adequacy do not allow for the real rate of predicted increase in life expectancy for retirees. The 2012 Actuaries Institute White Paper “Australia’s Longevity Tsunami – What Should We Do?”[16] states that “the more realistic scenario based on the cohort figures is that 65 year olds in 2050 will actually be living an extra six to eight years in retirement above the current reported life expectancy” – that is the average retiree living to 92 for males and 93 for females. Given that this is the average, many retirees will live longer.

Retirement phase – ensuring certainty and fairness

We strongly support retaining the existing tax settings applying to the retirement phase. Research published by ASFA[17] found that as the superannuation systems matures and

[16] http://www.actuaries.asn.au/Library/Submissions/Opinion/2012/AI-WP-Longevity-WEB050912.pdf p21
[17] The future of Australia’s super: a new framework for a better system, ASFA, November 2014

balances grow at retirement, members are increasingly using income streams to access their benefits in retirement.

Increasing taxes in retirement would further reduce adequacy for retirees, pushing a greater proportion of retirees onto the Age Pension as they outlive their superannuation funds.

Changing post-retirement tax settings would also damage confidence in the whole superannuation system, thereby reducing voluntary contributions made by those in the accumulation phase.

Furthermore, contribution caps during the accumulation phase prevent excessive pre-tax money being diverted into the concessional regime.

In combination, these existing settings mean that the vast majority of superannuation account balances will not reach the significantly high levels that would justify moderating the current concession available in the retirement phase. This is borne out by an examination of superannuation balances in Westpac/BT's superannuation products, where there are only 0.01% superannuation accounts and 0.27% of retirement accounts which have assets greater than $2.5 million[18].

Other tax changes that impact retirement accounts

The potential for changes to dividend imputation, as well as any potential change to the one-third capital gains tax discount that applies to superannuation funds, would also have a detrimental effect on the superannuation returns of all Australians and lead to lower eventual retirement benefits. This will increase reliance on the Age Pension and mean higher costs for the Government.

Very High Balances - maintaining fairness with targeted changes

To the extent that a small number of very large superannuation holdings are adversely affecting the perception of fairness in the superannuation system, we support appropriate changes to address those concerns. We favour specific, highly targeted measures aimed at curbing any distortions instead of widespread changes to the existing superannuation scheme that impact all members.

Where additional superannuation contributions originate from isolated transactions occurring outside superannuation, these could significantly boost existing retirement account balances. In many cases, concessional tax arrangements, including full tax exemption, may apply to these isolated transactions.

By boosting superannuation account balances, particularly by those nearing, or already in retirement phase, any earnings generated by and/or benefits taken from those accounts will be protected from further tax. This is in stark contrast to after-tax contributions that are made during the accumulation phase where, in almost all instances, personal tax has been paid at marginal tax rates.

If Government was concerned about the impact of very high balance retirement accounts, it could consider imposing a 'maximum retirement balance' ceiling, of say $2.5M, and prevent

[18] Ibid at 15 above

further amounts from being transferred into these accounts already in retirement phase. Any additional contributions could be kept in a separate accumulation fund where earnings would remain subject to 15% earnings tax. This approach would be simpler to administer, reduce distortions and also address fairness concerns.

Alternative reform options such as lifetime caps on concessional and non-concessional contributions are complex to administer both from an individual fund and public administration perspective.

In order to encourage retirees to protect themselves from longevity risk, Government could consider not counting towards the “maximum retirement balance” any assets used to purchase an eligible product designed to address longevity risk, such as an annuity, a deferred annuity or a GSA (Group Self-Annuitisation) product which addresses longevity risk via pooling rather than insurance (such as the recently released Mercer product[19]).

Another option could be to create a new taxing point (i.e. a CGT event) for gains accrued during accumulation phase that have not already been taxed (but allowing appropriate deferral of payment to when as asset is sold). This would address the issue where assets are held until pension phase and then being sold in a tax-free environment.

Lump sum withdrawals

To the extent that benefits are being taken out of the superannuation system, we do not see the need for changes to the current tax arrangements for lump sum withdrawals. Research has shown that most retirees already annuitise their assets into vehicles such as account based pensions. In fact, more than 82% of retirement funds under management are invested in income streams with the remainder being taken as lump sums[20].

There is little evidence of “double dipping” the Age Pension through lump sum withdrawals early in retirement, and most such withdrawals are made by retirees with small balances (recognising that there is little or no value in annuitising small balances).

Restrictions on withdrawals or increasing the taxation of withdrawals would be detrimental to low income earners and, in particular, where the primary objective of the withdrawal is to reduce a person’s indebtedness. According to the Australian Bureau of Statistics, 29% of retires who took lump sums invested it in their own homes (including paying down their mortgage), followed by 20% who reinvested as ordinary money and 12% that paid off debt. Only a combined 22% said they bought a car, paid for a holiday or assisted family[21].

Aligning with the Financial System Inquiry

In our submission to the Financial System Inquiry, Westpac has endorsed a proposal recommended by the Inquiry for a comprehensive income product (CIPR) to be developed.

[19] Mercer LifetimePlus™ is designed to protect Australians against longevity risk - the risk of outliving savings.
[20] Rice Warner 2015 prepared for Colonial First State
[21] According to the Australian Bureau of Statistics, Retirement and Retirement Intentions 2013

In this context, the current tax arrangements applying to the retirement phase support the overwhelming number of participants that convert retirement assets into income streams. It is estimated that approximately 85%[22] of funds are converted into income streams.

It is vital that the superannuation tax arrangements in this area remain stable and certain as this will facilitate the development of better products and more sustainable outcomes.

Transitional Arrangements

To ensure overall equity and fairness, any proposed changes to the superannuation tax arrangements considered by Government should only operate prospectively.

[22] Mercer – David Knox, Sourced from Oliver Wyman, Centrelink, Plan for Life, APRA

Chapter 3 – General Business Taxes

Introduction

Consistent with the trend in OECD countries, Westpac supports lowering Australia's corporate tax rate over time. Reducing the corporate tax rate should lead to greater economic activity and improve the stability of the corporate tax base.

We also believe the dividend imputation system continues to serve Australia's interests and should be retained. We do not support abolition of dividend imputation as a trade-off for lowering the corporate tax rate.

Response Question

24	**How important is Australia's corporate tax rate in attracting foreign investment? How should Australia respond to the global trend of reduced corporate tax rates?**

Westpac's view

The company tax rate should be reduced at an appropriate time.

We note the commentary in the Discussion Paper which argues that lowering the corporate tax rate would lead to "higher levels of investment in Australia and lead to capital deepening, which promotes growth in productivity, innovation, employment and wages".

Whilst this is intuitively true, we are not aware of any empirical evidence which would prove this definitively, although several reports suggest that these flow-on benefits would occur. These include the Business Council of Australia[23] and Treasury[24]. The study by Treasury is based on an assumption that the marginal investor into Australia is a foreigner[25].

In Westpac's case, the majority of our shareholders are Australian residents, and the majority of our funding is domestically sourced. Therefore, whilst lowering the company tax rate may generate some increase in marginal offshore investment, the impact for Westpac is currently not expected to be significant.

[23] The Future of Tax, Australia's Current Tax System, September 2014
[24] Rimmer, Smith and Wende, *The incidence of company tax in Australia*, Economic Roundup, Issue 1 2014 Treasury.
[25] Ibid, at page 46.

The amounts for Westpac for the period ended 31 March 2015 are as follows:

	Deposits[26]	Wholesale Funding	Equity[27]
Resident	353,841	91,000	38,794
Non-resident	66,410	143,000	11,522
Total	420,251	234,000	50,317[28]

Given this funding and investor mix, and the operation of the dividend imputation system, Westpac does not see that a reduction in the company tax rate would significantly alter our funding or investor mix or significantly affect our investment plans or profile.

However, a reduction of the corporate tax rate over time is likely to have additional beneficial impacts relating to a more sustainable corporate tax base arising from:

- less reliance on corporate income tax revenue by the Government – as the Henry Review recognised, a reliance on corporate income tax revenue is not efficient and has long term costs for economic growth and living standards[29];
- less incentive for companies to engage in tax planning and/or profit shifting[30]; and
- a more competitive comparative tax base compared to other OECD and Asian countries[31].

Response Question

25 Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?

Westpac's view

We believe that the dividend imputation system continues to serve Australia's interests at this time.

Supporting Arguments

It eliminates double tax

The abolition of dividend imputation will bring Australia back to the position it was in prior to 1987. Double tax would be payable. Profits would be taxed at the company level (currently at the rate of 30%), and then again at the individual level (at marginal tax rates).

[26] Westpac half year accounts 2015, page 17
[27] Westpac also has hybrids on issue, the vast majority of which are owned by Australian resident investors
[28] Total shareholder equity per Westpac half year accounts 2015, and which includes retained earnings.
[29] Henry Review, Volume 1, page 152
[30] Business Tax Working Group, Final Report, 1 November 2012, page 4, paragraph 30
[31] OECD Table of Comparative Tax Rates, and table of comparison tax rates to Asian Jurisdictions

For an investor at the highest marginal tax rate, this would give rise to an effective tax rate of 64.3%.

The prospect of double tax gives rise to equity and efficiency problems, including:

- a disincentive for businesses to incorporate, particularly where the corporate and personal tax rates are high;
- a distortion in corporate finance decisions by providing a bias towards debt as opposed to equity; and
- Companies choosing to retain profits in favour of distributing profits to shareholders, particularly when capital gains have preferential tax treatment.

Imputation eliminates double taxation of dividends and provides neutrality with respect to the tax treatment of investor returns from incorporated and unincorporated entities.

It creates an incentive for Australian companies to pay Australian tax.

Dividend imputation also contributes to boosting the integrity of the tax system. This is due to the fact companies seeking to generate franking credits must pay income tax in Australia. Ultimately, the benefit to the tax system is that companies and their shareholders are encouraged to pay tax rather than seeking ways to minimise or defer their tax obligations.

Tax administration and compliance costs are also reduced as companies spend fewer resources on trying to minimise tax paid. A second order effect is the lower monitoring required under the general anti-avoidance rules.

Companies owned by domestic retail shareholders, superannuation funds and by Australian institutional investors and which have a history of paying franked dividends, make sure that sufficient Australian tax is paid in order to continue paying fully franked dividends.

This means that even Australian-owned multinationals have an incentive to conduct a certain amount of business in Australia, rather than offshore, in order to frank their dividends.

There are also studies that suggest a dividend imputation system in a country gives rise to increased company income tax[32].

Adverse impact on retirement accounts and earnings

Many Australians hold shares in Australian companies directly, or through their superannuation funds[33]. Dividends from these shares represent a vital source of income for many people in retirement and the value of share investments in retirement accounts represent an increasingly important asset base.

In isolation, the abolition of dividend imputation will have significant adverse implications for share values. The loss of imputation credits would increase the tax burden on shareholders.

[32] Markle & Shackleford, 2009

[33] For households, shares make up over 2% of all household asset (ABS statistics for 2011-2012). For superannuation funds, approximately 25%-30% of their assets are Australian shares (Westpac Initial Submission to the FSI, March 2014, page 40).

Abolishing dividend imputation may also lead to companies reducing dividend payout ratios. Reduced dividend payouts would further reduce retirement incomes and see a decline in share prices.

Lower retirement account balances and incomes would likely place additional pressure on the Government to support retirees through the Age Pension.

It provides for a lower cost of capital for companies

Dividend imputation provides all Australian companies with access to a deepened pool of capital to fund future investment needs. Dividend imputation encourages domestic business investment by reducing the cost of capital for domestically owned companies. Imputation may bias Australian companies owned by residents towards investing in Australia rather than overseas.

Imputation is more likely to reduce the cost of capital for smaller and unlisted Australian companies, particularly when they are setting up or raising new equity. These companies have more limited access to international capital and, therefore, a higher reliance on domestic savings.

Domestic investors would prefer a return with attached imputation credits, which can be used to offset tax payable.

Strengthen Corporate Balance Sheets

The imputation system neutralises the tax bias for debt in funding a company. It is important that companies have the appropriate balance between debt and equity, and that this decision reflects commercial considerations.

The use of debt can give rise to a tax induced bias in financing decisions as the absence of dividend imputation would favour tax deductible debt funding rather than non-deductible equity funding. The increased neutrality brought about by imputation has contributed to lower levels of corporate gearing[34]. This has strengthened Australian corporate balance sheets, and contributed to the strength of the Australian corporate sector during the GFC.

Corporate Efficiency

Australian shareholders prefer to receive fully franked dividends. To meet shareholder demand (and to maximise its share price) corporates need to manage their operations efficiently. This means that corporates have an incentive to make wise investment decisions so that they are in a position to pay out more profits as franked dividends and to not accumulate excess cash, or invest in more marginal projects.

Share price impact

The price of Australian Shares is driven by demand and supply. Australian investors prefer dividends with attached imputation credits. Abolishing dividend imputation would reduce the market value of these shares.

[34] *'Australia as a Financial Centre',* Report by the Australian Financial Centre Forum, November 2009,

The abolition of imputation would result in the after tax return of dividends falling by up to 30%. While any decline in value of shares is difficult to determine, it is not unreasonable to estimate that any impact would be material.

Benefiting non-resident shareholders over domestic investors

Removing dividend imputation will result in a relative detriment to the Australian investor compared to non-resident shareholders, particularly where there is a corresponding reduction in the corporate tax rate[35]. Whilst we accept that the Australian investor's loss of value and additional tax burden may be reduced through some alternative relief for dividend income, it is not apparent to us that domestic shareholders would be fully compensated for their loss.

We would further argue that alternative measures of providing shareholder relief cannot match the manifest integrity benefits that accrue under a dividend imputation regime.

[35] In a relative sense, the foreign shareholder's after tax return will increase due to the reduction in the corporate tax rate whereas the after tax return of the Australian shareholder is likely to reduce.

Chapter 4 – GST and State Taxes

Introduction

We agree with the broad proposition that the States and Territories require efficient and effective tax arrangements in order to deliver services to their communities.

In this regard, we agree that a review of the GST in conjunction with a review of state taxes should be undertaken. Changes to either the GST or state taxes should only be made where the outcome leads to lower, simpler and fairer tax outcomes.

Response Questions

51 To what extent are the tax settings (that is, the rate, base and administration) for the GST appropriate? What changes, if any, could be made to these settings to make a better tax system to deliver taxes that are lower, simpler, fairer?

52 What are the relative priorities for state and local tax reform and why? In considering reform opportunities for particular state taxes, what are the broader considerations that need to be taken into account to balance equity, efficiency and transitional costs?

Westpac's view

Reforming State Taxes and the GST

There are considerable obstacles associated with reforming GST and state taxes. This is due to the combination of the embedded nature of certain state taxes, differential legislative regimes and fiscal priorities and the potential distributional impacts of taxes such as the GST.

In our view, priority should be given to removing inefficient state taxes and carrying out a review of the GST settings. Inefficient state taxes are harmful to economic activity, highly volatile and difficult to administer.

In particular, we would support measures that involve reducing the reliance on stamp duties and reducing the overall number of other state taxes and levies. Given that the states also receive all GST revenues, an analysis of the GST settings should also be undertaken.

Goods and Services Tax

Whilst it is possible to make a case for increasing the GST rate and/or removing GST exemptions, unless inefficient state taxes are removed and adequate compensation paid to address equity concerns, the overall tax burden will be greater.

Under current settings and tax arrangements, any increase in the GST rate will add significant GST cost to financial institutions and mean that financial services will cost more. This will lead to an increase in the overall tax cascade and may lead to financial suppliers insourcing activities currently outsourced.

Imposing Additional Taxes on Financial Services

We do not agree that there should be additional indirect taxes imposed on financial services whether in the form of GST, duties or other forms of financial transaction taxes.

GST

Extending GST to the majority of financial services will mean higher costs for consumers. In this regard, several important considerations need to be taken into account. The overwhelming evidence[36] is that explicit taxation of financial intermediation using a GST regime is difficult to accomplish. This is why it has been rejected by the vast majority of countries that operate VAT/GST regimes.

International VAT/GST regimes that have looked at taxing financial intermediation have concluded that interest margin does not necessarily reflect an intermediary's 'value-add'[37]. Furthermore, borrowing and lending does not represent 'consumption' and thus a consumption tax approach is deemed unsuitable[38]. We agree with these observations and conclusions.

Transaction Taxes

Transaction taxes or duties imposed on financial transactions will increase the cost of financial services for all customers and place Australia at a competitive disadvantage compared to other financial centres.

Stamp Duties and Land Taxes

We agree that there are numerous advantages associated with the taxation of land based on a broad-based land tax compared to the transaction-based approach. Land taxes are more efficient, difficult to evade and they are able to be applied equitably to ensure overall progressivity is maintained.

In making a change towards broad-based land tax there are a number of transitional issues which need to be considered. These include the impact on household incomes, debt serviceability, housing affordability and values.

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[36] See also Grubert and Krever, *VAT and Financial Supplies. What should be taxed?*, Oxford University Centre for Business Taxation 2010

[37] Ibid

[38] See also De La Feria and Walpole, *Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared*, Cambridge Journals, 2009

To a large degree, the impact of shifting towards a broad-based land tax approach will be influenced by the pace of change and the framework for transition.

Sudden changes and shifts are more likely to create shocks in the value of land and affect people's capacity to pay.

An increase in land taxes would impact disposable incomes of all home owners. Households with low incomes and those on pensions will potentially require concessional tax treatment or other assistance. For owner-occupiers with mortgages, any change will also impact their capacity to repay debt. Investors are likely to pass on the cost to renters, meaning that rents may increase.

In this regard a staged medium-term transition, such as that commenced by the ACT government, would seem less likely to lead to significant distortions.

Insurance Duties and Taxes

Underinsurance is a major risk to Australian households and businesses. It exposes customers to significant loss if the sum insured is inadequate and cannot cover the cost of rebuilding or repair after total loss or damage is incurred.

The extent of underinsurance is widespread across Australia and several reports over many years have confirmed this. For instance, a survey by ASIC of 1,000 randomly selected households by a company specialising in estimating rebuilding costs found that:

- 87% of homes were insured for less than their replacement value and that the average level of underinsurance was 34%;
- 81% of homes were underinsured by 10% or more; and
- 59% of homes were underinsured by 30% or more.

While there a range of factors which contribute to underinsurance, we believe that one of the key drivers is the affordability of insurance. Insurance taxes impact the overall affordability of insurance and can distort the purchasing behaviour of consumers such that they either choose not to purchase insurance, reduce their level of cover, or increase their excess to reduce their total insurance premium.

Any negative impact on the level of non-insurance ultimately leads to calls for government to step in and ultimately fund disaster recovery for those people with no insurance. This in turn reduces the perceived benefits of insurance and drives levels of non-insurance even further, creating a vicious circle.

The Henry Review in 2010 recognised this and recommended the removal of state based duties as soon as possible, with only the GST being applicable to insurance premiums (excluding Life Insurance).

Westpac supports the recommendations of the Henry Review that state governments should abolish all state duties and taxes on insurance as this will minimise the effects of non-insurance and underinsurance.

Chapter 5 – Other Issues

Response Question

37	**Are there other important issues in the business tax system, not covered in this section, which should be considered as part of the Tax White Paper process?**

Westpac's view

Financial Claims Scheme

Westpac supports the continuation of the Financial Claims Scheme (FCS) as a post-funded scheme. Westpac does not believe that the FCS should be pre-funded.

Due to high loan to deposit ratios in Australia, local depositors are well covered by high quality assets (largely residential mortgages). In the event of bank failure, it is likely that wholesale debt financiers will be most at risk of loss. Australia's deposit preference regime also protects depositors in the event of bank failure.

Furthermore, any pre-funded levy for the FCS would need to consider the risk of moral hazard and the potential for risk-based pricing. It would also be an additional cost on banks that may be borne by depositors. This would erode customer savings and further reduce the attractiveness of bank deposits relative to other classes of assets.

Interest Withholding Tax

There should be an exemption from interest withholding tax for funds raised from non-residents by Australian based financial institutions.

Australia imposes withholding tax on interest paid from Australia to offshore, with the primary liability falling on the foreign lender. The market convention is that the interest withholding tax[39] cost will not be absorbed by the foreign lenders, so in practical terms it increases the cost of funds to the Australian borrower. Such a cost is prohibitive, and, as a result, funding from sources where an interest withholding tax is imposed will not be accessed.

Whilst there are certain exemptions[40], there is currently no exemption for deposits raised by Australian banks from offshore customers. In fact, the current rules contain compliance requirements and favour Australian financial institutions raising funds offshore through wholesale markets, increasing their vulnerability in periods of stress and financial turmoil[41].

[39] The rate is 10% of the gross amount of interest paid

[40] The main being for: (a) borrowing from non-residents through the public offer of debentures or debt interests; and (b) borrowing from a financial institution that is resident in a county that has a comprehensive double tax treaty with Australia.

[41] Page 181, Henry review, 2009

Supporting Arguments

Extending the interest withholding tax exemption to offshore retail deposits would provide Australian financial institutions with access to a more diverse and stable form of offshore funding.

Westpac does not believe there would be a significant loss in revenue from broadening the exemption from interest withholding tax, as the Australian Banks do not currently access offshore funding which is subject to interest withholding tax.

Improved access to a more diverse and reliable funding source may reduce the cost of funds for Australian Banks. Any such reduction would likely be passed onto Australian business and households that borrow from banks, which, in turn, should stimulate economic activity.

Summary

In summary, the exemption from interest withholding tax:

- has the potential to expand Australia's offshore funding capacity (including providing access to retail deposits);
- will provide a higher quality more diverse and sustainable funding base; and
- put the Australian banking system in a more competitive position vis a viz its offshore competitors – as other jurisdictions do not have this withholding tax imposition that restricts access to funding in certain markets.

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