AUSTRALIAN BANKERS' ASSOCIATION INC.

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AFTS Secretariat
The Treasury
Langton Crescent
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Dear AFTS Secretariat,

Australia's future tax system: Positioning for growth

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

The ABA is keen to be closely involved and to support this important project as it unfolds.

The Attachment to this letter sets out seven key tax reforms for the Review to consider. The proposals are driven by our view on where the current problems that affect the efficiency and equity 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.

Consistent with the terms of the reference of the Review, the 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.

These goals coincide with those identified in the Review's first discussion paper, *Architecture of Australia's Tax and Transfer System* (August 2008) and touch especially on matters raised in chapters 6, 8, 9, 10 and 11 therein.

The seven key proposals we ask the Review to examine are to:

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

(2) Eliminate interest withholding tax on foreign-raised funding, including offshore deposits, by Australian financial institution groups.

(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 including the GST-free treatment of all financial supplies, or, at the very least, the GST-free treatment of B2B financial supplies.

Fuller descriptions of each proposal, and the explanation of how each proposal addresses a priority concern, are set out in more detail in the Attachment to this letter.

We have assumed that this is not the stage in the Review process for detailed descriptions of the mechanisms for delivering each of the seven key proposals, or for elaborating the revenue and distributional implications of the proposals.

We can provide further information on such matters at a later stage to assist your deliberations.

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 ABA reiterates the importance of the Review's work and the need for a full consideration of the shape of Australia's future tax-transfer system. The ABA would welcome the opportunity for ongoing consultation with the Review as its work progresses.

Yours faithfully,

Tony Burke

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

Australia's Future Tax System

Positioning for Growth

Initial submission of the Australian Bankers' Association to the Review

17 October 2008

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Initial submission of the Australian Bankers' Association to the Review

1. Introductory comments

Australia is very well placed to maintain a strong level of economic growth over the medium to long term for the benefit of its citizens, even allowing for an ageing population, the pressing need to address the challenges of climate change and some worrying signs in the short to medium term.

Large parts of Asia, representing more than a third of the world's population, are presently experiencing transformation of material living standards (and aspirations) on a vast scale – without parallel in human history. This inexorable process, with unprecedented levels of urbanisation and industrialisation, will have its ups and downs, but is likely to have decades to run.

Our role in the "Asia story" is not limited to our geographical proximity to this fast evolving region, and our enormous reserves of physical resources that will be demanded by neighbouring countries for many years to come.

Australia has a sophisticated services sector, including but not limited to financial services, which stands to contribute to and benefit from the development of Asian economies.

We have a strong and stable system of government, underpinned by the rule of law, and a well educated and culturally diverse workforce. Australia is a country that should do well out of the Asian expansion, but nothing can be taken for granted. We need to continually ensure that our economy and support systems (including our revenue system) are positioned for growth.

The primary role of a country's tax-transfer system is to raise revenue for expenditure on social goods and services, as well as to make welfare payments to those judged to be in need. In doing these tasks, the tax-transfer system should at the least be designed to minimise adverse impacts on economic growth, and as far as possible, to enhance the prospects of such growth.

The present Australian tax-transfer system is not terminally broken, and indeed has served us reasonably well to this point. However, the system is far from optimal and is certainly in need of reform – this much is clear from the Review's own discussion paper *Architecture of Australia's tax and transfer system* (**Architecture**) released in August 2008.

The ABA agrees, for the reasons expressed in section 1.3 of Architecture, that now is indeed the right time to contemplate, design and implement Australia's future tax system.

It is self-evident that the global financial system, and increasingly, global economic "health" more generally, have deteriorated significantly since the Review was announced, even since Architecture was released in August. Australia's short term growth prospects are not as clear or as strong as they were six months ago. However, this should be no cause to take "the foot off the pedal" as regards tax reform, which inevitably will be at least a medium term project and the results of which will need to last for many years. Broadly speaking, over the longer term, periods of economic stagnation or even recession are substantially outweighed by periods of economic well-being.

Mindset is important. The tax-transfer system needs to be re-designed by asking the question: "*how will the rules promote economic growth and a fair distribution of the burden of revenue?*" rather than by asking the traditional question: "*how can we design the system to chase every last dollar of revenue?*"

2. What major challenges (and opportunities) facing Australia need to be addressed through the tax-transfer system?

By way of an opening comment, the ABA agrees with the following "emerging challenges" as summarised in section 1.2 of Architecture:

- a likely slowing of economic growth due to our ageing population;
- climate change;
- pressure for the tax-transfer system to *remain* internationally competitive; and
- the nature of our federation and the need to ensure "coordinated action" across Federal and State/Territory governments.

2.1 International competitiveness: a challenge

As will be seen, a theme of this submission is international competitiveness – the challenge is to "become" rather than "remain" internationally competitive, especially with our Asian neighbours. To enhance Australia's status as an attractive place for business and investment, the tax system needs to be designed to ensure it can adapt to the increasingly integrated global business environment. Australia needs to recognise changes and developments in the tax systems of countries which compete with Australia for mobile capital and investment flows.

Architecture itself notes that we have a higher tax burden on capital income than the OECD and Asian average. Given the increasing mobility of global capital, our current lack of competitiveness is not sustainable and needs to be a key focus of the Review.

2.2 Access to funding and capital: a challenge

Access by the private business sector to reliable and reasonably priced debt funding and equity capital is the lifeblood of Australia, and indeed any, market-based economy. Without such cash flow, there can be no investment, no new jobs and no economic prosperity.

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".

The current worldwide financial crisis is ample evidence of the need for reliable access to funding and capital. The Federal Government recently recognised this when it announced that it would provide guarantees in relation to term debt funding obtained by Australian financial institutions from overseas wholesale funding markets. Relatively speaking, Australia is weathering this global storm better than many other countries. As is clear from the Reserve Bank's recent comments[1], this is not luck.

The International Monetary Fund (**IMF**) recently noted that for both the Australian and New Zealand central banks:

> *"sound fiscal positions provide scope for allowing automatic stabilizers to operate in full and for judicious use of discretionary stimulus if the outlook deteriorates further."*[2]

The IMF's September 2008 Country Report, while confirming vulnerabilities remain, emphasised the following:

> *"Directors considered that the banking system is sound…They commended the authorities' timely and fitting response to the credit market turmoil…Directors noted that the banking sector remains profitable and well capitalized."*[3]

Amongst other reasons, Australia has a sound, well regulated banking and financial system, with well managed financial institutions. In these respects, we are the envy of many other nations. However, going forward, this is not enough.

There are significant "blockages" and distortions in the current availability of funding and capital to the Australian business sector that can and should be addressed by reforms to the tax-transfer system.

2.3 The global war for human capital: a challenge

Just as financial capital has become more mobile, so have people. Economic growth, coupled with an ageing population (and a shrinking workforce) in many countries is leading to a battle between nations for skilled and unskilled human resources.

While there may be a brief lull caused by the current global financial crisis, this struggle is only likely to intensify in coming years, given that the demographic shift in the population has a long way to play out.

Other countries are using their tax-transfer systems to retain and entice workers. Australia does this to an extent – but more is needed.

2.4 Climate change: a challenge

There are immense policy challenges in the global response to climate change. In relation to the tax-transfer system, issues include confirming the means by which

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[1] See Reserve Bank of Australia, *Financial Stability Review*, September 2008.

[2] World Economic Outlook, October 2008, p.83

[3] Australia: 2008 Article IV Consultation—Staff Report, p.3

redistributions through the payment system to facilitate the transition to the carbon pollution reduction scheme, as well as specific matters such as FBT calculations, which can for example encourage increased vehicle use.

2.5 Australia's financial services sector: an opportunity

The Australian financial services sector, underpinned by strong, stable and sound institutions, aims to deliver world-class service efficiently to Australian consumers, business and government. The sector remains committed to serving all sectors of Australia's society and economy and to continuing to grow its economic contribution to GDP, tax revenue and jobs – thereby helping to facilitate the development of the broader Australian economy.

To achieve the above ends, the ABA believes that Australia must maintain a core of locally owned institutions, complemented by a meaningful presence by foreign financial institutions.

Furthermore, Australia's locally owned financial institutions should be encouraged to develop globally competitive scale (or in the long run they will not remain locally owned), so as to ensure that at least some of them can expand internationally, particularly in Asia, and further build on Australia's existing reputation and attractiveness as a destination for international financial services business.

This objective has been recognised as a priority by the Australian Government. The specific proposals in this submission, by strengthening Australia's financial sector, will contribute to this government priority as well as serving the other objectives identified.

Targeted enhancements to the tax-transfer system have an important role to play in the further development of the Australian financial services sector.

3. What features should the tax-transfer system have in order to respond to those challenges (and opportunities)?

3.1 Review's Terms of Reference

The ABA broadly supports item 2 in the Review's Terms of Reference which captures the essence of the usual attributes of good tax system design:

> *"Raising revenue should be done so as to do least harm to economic **efficiency**, provide **equity** (horizontal, vertical and inter-generational), and **minimise complexity** for taxpayers and the community"* (emphasis added)

3.2 The importance of minimising complexity: certainty and simplicity

The minimisation of complexity means lower compliance and administrative costs to which significant contributions are made by certainty and simplicity[4] (reduction of complexity in the law and its operation).

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[4] Certainty and simplicity have been key hallmarks of a good tax system at least since the time of Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations* in 1776: see the segment "Of Taxes" in Part 2 of Chapter II of Book Five.

The ABA strongly urges that in particular, the principles of *certainty* and *simplicity* be at the forefront of policy development. Australia is regularly cited by academics and other commentators as having the second most complex and unwieldy tax legislation in the world (after the United States) and, according to even ATO sponsored studies, the highest compliance costs in the world.

For a country of not much more than 21 million people, these are unnecessary and burdensome characteristics. In addition, many areas of tax law are bedevilled by unacceptably high levels of uncertainty, which deter or delay business and investment decisions and lead to negative economic efficiency consequences.

3.3 Frame legislation in terms of policy

At the risk of stating the obvious, tax laws should be carefully written so as to be clearly framed in terms of the applicable government policy. This will assist in interpretation and administration of the law by taxpayers, their advisers, the ATO and the Courts.

Although we say that this principle should be obvious, we raise it because it is in fact not always evident in Australian's current revenue laws. It is critical that any new or amended tax laws coming out of the Review be framed with close regard to the underlying policy.

4. What are the problems with the current system and what reforms do we need to address those problems?

Set out below are seven key problem areas with the current tax-transfer system which from the perspective of the ABA and its members are especially in need of reform.

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 problems have each been "mapped" to one or more key themes which 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 are:

(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.

It is important to note that in the ABA's view, suggested reforms in *each* of the seven areas noted below will assist in relation to the third "theme" above, i.e. enhancing Australia's position as a strong and influential financial centre. Accordingly, and for brevity, we have not listed this theme against each area, but it should be assumed.

4.1 International competitiveness: 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

Architecture notes that the Australian company tax rate (30%) is now above the OECD average. This is clearly a matter for concern as international literature suggests that the headline rate is a significant factor in investment and location decisions. There is a world wide trend for corporate tax rates to decline. In recent times the UK has reduced its rate from 30% to 28%.

Further, a more relevant comparison going forward is with our Asian neighbours. The corporate tax rates of countries like Hong Kong (16.5%), Malaysia (28%), Singapore (18%) and South Korea (13% and 25%), are better comparators because it is countries like these that are Australia's competitors as a choice for locating business operations. On this basis, the Australian headline rate of 30% is significantly and adversely out of step.

In order to enhance Australia's international competitiveness, the corporate tax rate needs to be reduced. Reductions to the rate should be considered both in the short term and in the medium to long term as changing economic circumstances allow.

It should be noted that a cut in the rate of corporate tax mainly benefits non-resident investors because of the Australian imputation system, which means that the revenue cost of cutting the rate is less than comparable rate cuts in many other countries. A cut in the rate would attract more investment into Australia which needs to be factored into revenue estimates for such a policy.

It is important to look not just at the "headline" or statutory company tax rate, but at the "effective" tax rate, i.e. the rate of tax being a function of the tax expense in a company's financial accounts and its financial accounting profit adjusted for so-called "permanent differences" between accounting and tax income.

As a result of reforms following the (Ralph) Review of Business Taxation in 1999, there has been an increase in the effective tax rate (compared to the statutory rate) due to base-broadening measures and the removal of various concessions. Comparing headline rates does not capture this dimension.

Effective tax rates also affect investment decisions and more importantly, may have adverse cross-industry efficiency effects in two dimensions. From the point of view of the domestic economy, differing effective tax rates can have efficiency consequences if the rates vary significantly across sectors (the precise outcome depending on whether the capacity to frank dividends is affected). The banking industry consistently has one of the highest *effective* tax rates across Australian industry[5].

Further, in comparing effective tax rates it is necessary to look across borders. If a particular industry has a low effective tax rate around the world (such as shipping) then any country which seeks to have a substantial industry in the area has to have regard to the international competitiveness of effective tax rates for that industry. One area that is of concern in this regard is the limited and prescriptive nature of Australia's OBU regime which affects international competitiveness of Australian banks.

In a number of important areas the measurement of "income" in Australia for taxation purposes is currently not correct and overstates economic income. Some of these cases affect business generally, such as the write-off of intangibles and the continuing existence of other "black-holes", while others have a particular impact on banking, such as bad debt provisions.

A significant reduction in the headline corporate tax rate *and* removal of over-measurement of income are both necessary to ensure that Australia remains attractive to global business and is internationally competitive in the banking sector. Specific international competitiveness issues also need to be addressed.

4.2 Access to stable funding and capital: eliminate interest withholding tax on foreign-raised funding, including offshore deposits, by Australian financial institution groups

Australia already has several exemptions from interest withholding tax, which otherwise generally applies (broadly speaking) at the rate of 10% on the gross amount of interest paid by Australian borrowers to non-resident lenders.

The main exemptions are for institutions which raise debt through the "public offer" of debentures to non-residents, for foreign superannuation funds and the more recent exemptions for financial institutions in Australia's tax treaties negotiated since 2001. There are no exemptions currently available for deposits raised by Australian banks from offshore customers.

Because the existing exemptions are both incomplete and subject to serious constraints, they effectively deny Australian banks and other borrowers access to cost effective funding from a variety of foreign sources, most importantly wholesale funding sources which have been impacted severely by the current worldwide crisis. Extending the exemption to offshore customer deposits would have the additional benefit of diversifying the sources of funds available to Australian banks.

Since the market convention is that foreign lenders will not "absorb" Australian interest withholding tax, the existence of withholding taxes distorts the flow of funds in global capital markets and in practical terms increases the cost of funds to Australian borrowers.

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[5] See Figures 1 and 2 in *Effective Tax Rates of Corporate Australia and the Book-Tax Income Gap*, Alfred Tran and Yi Heng Yu, (2008) 23 Australian Tax Forum, page 233 at pages 262 and 263. The general narrowing in Australia of the gap between nominal and effective tax rates in recent years as noted in Architecture Chart 6.7 does not capture this variability across sectors.

That is, it would be necessary for the Australian borrower to "gross up" the interest payments and thus effectively bear the withholding tax itself. Such a cost is prohibitive. As a result, such funding from wholesale sources is typically not accessed (where no exemption exists) by Australian banks and other borrowers and no interest withholding tax revenue arises for the Government. Banks are effectively cut off from certain pools of liquidity in global capital markets (at least when the markets are functioning normally, which is the bulk of the time) with no taxation benefit to the Government.

Under the current regime, if Australian banks raise deposits overseas (excluding certain categories of tax exempt investors such as central banks), those deposits are subject to interest withholding tax when directly repatriated to Australia. As a result, Australian banks generally do not raise and directly repatriate deposits. Once again the Government raises nil revenue and the Australian banks are effectively cut off from these pools of liquidity. Foreign banks, including Singaporean and Hong Kong based banks, are instead able to globalise their pool of funds, to ensure better access to diversified funding sources.

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.

The existing exemptions referred to above reflect a progressive but limited recognition of this policy driver in international capital markets.

In addition, the Australian Government now recognises, as seen from several recent statements and actions in response to the ongoing international credit crisis, that overseas sources are a vital element in funding Australian financial institutions, particularly banks. Against this background the most efficient economic outcome is to place such overseas sources of debt funding on an equal tax basis in Australia.

The international trend is for broader reduction/elimination of interest withholding taxes in many cases. Many OECD countries with major banking industries now prefer to include a blanket zero rate on interest in their tax treaties and countries are also introducing more exemptions in domestic law. For a country comparable to Australia, recent Canadian action is illuminating. In 2007 Canada negotiated with the US a phased elimination of withholding tax on interest and similarly announced abolition of the tax generally for arm's length interest. The UK also exempts from interest withholding tax interest paid by banks to non-residents in the ordinary course of their business.

Accordingly, the ABA recommends that the time has come for a simple broad exemption from interest withholding tax for the funding of the operations of financial institutions in Australia, especially banks, which could take a number of forms, e.g.:

- to apply to all interest received by all non-residents from the Australian operations of financial institution groups (preferable approach); or, at the very least,
- to apply to all foreign-raised *wholesale* funding by Australian operations of financial institution groups, including all funding from foreign financial institutions.

The exemption should be implemented in such a way that it avoids unnecessary conditions that stand in the way of broad market access, for example, avoiding some of the problems in relation to the current treaty exemption used by Australia, including:

- the limitation which prevents Australian financial entities borrowing from related foreign financial entities;
- the slowness of extending the exemption by treaty;
- coverage of affiliates of Australian financial entities especially subsidiaries and various special purpose vehicles that raise funds offshore; and
- the narrow interpretation of the exemption by the ATO.

It should be noted that both alternatives focus on the nature of the borrower, not the lender, in contrast to the treaty exemption. Hence it would not replace the need for the treaty exemption for non-financial institutions and for addressing problems in the current treaty-based exemptions.

The exemption should be available to financial institution groups (including subsidiaries and special purpose vehicles) operating in Australia – whether resident (e.g. Australian incorporated ADIs) or non-resident (e.g. Australian branches of foreign banks) for tax purposes.

If any exemption is limited to wholesale funding sources (which would be a "second best" outcome), these need to be defined in a way which is clear and broad so that the exemption operates as intended and is flexible enough to deal with future market developments in wholesale funding.

Such a move will:

- increase market liquidity significantly;
- diversify the sources of funds available to Australian banks and other borrowers;
- in a competitive market, enable this greater access to lower cost funding by Australian borrowers (especially banks) to flow on to their dealings with their customers, e.g. through lower domestic interest rates; and
- enhance Australia's credentials as a financial services centre.

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

It is well known that the proportion of bank funding sourced from deposits is falling relative to bank asset growth. The size of the fall is quite dramatic and should be a matter of great concern to policy makers. This bank funding vulnerability has been recognised by the Rudd Government in the context of the current financial crisis. In particular, it announced on 12 October that, as one of three new measures to maintain the stability of the financial system, it will guarantee the term wholesale funding of local banks until global financial markets stabilise.

Over the last decade, the proportion of bank deposits sourced from households and businesses declined from 64% of total bank assets to around 55% today – a decline of 14%. Applying these ratios just to the major 4 banks, this reduction of 14% equates to around $120 billion in today's dollars. In other words, a gap of $120 billion has had to be sourced elsewhere to fund bank asset growth. This, of course, has been done through the issuance of other kinds of debt instruments in Australia and overseas.

Until recently, banks have met the deposit shortfall challenge with relative ease, assisted by strong credit ratings, a robust domestic economy and sound regulatory system. However, this situation changed with the current financial crisis, and there is the potential for difficulties in the future if banks continue to meet the economic need for credit expansion.

For instance, assuming the ratio of deposits to assets remains constant, for every 10% increase in bank assets, the major 4 banks alone will need to find around $50 billion in non-deposit funding. If the deposit rate continues its long-term trend downward, then the non-deposit funding gap gets even greater.

Commensurate with a reduction in the household saving rate, a number of factors have contributed to a reduction in deposit funding. These factors include: a low interest rate and low inflation environment; rising asset values (in both equities and residential real estate); financial deregulation, the extension of the social safety net and economic prosperity[6].

Whilst there may be many reasons for the drop-off in deposit funding, chart 8.4 of Architecture shows one reason very starkly – that "bank bonds" (e.g. interest income from term deposits and other bank accounts) is subject to a higher effective marginal tax rate than any other asset type/class of investment.

It is not surprising, therefore, that investor appetite for such investments has waned over the years – given the more favourable (in some cases, much more favourable) tax treatment applicable to owner occupied housing, rental property, listed shares and superannuation.

Currently, term-deposits have no taxation incentives at all. Every dollar earned by an individual through a term-deposit is taxed at the person's full marginal tax rate. This contrasts with concessional tax treatment on the earnings of

[6] (Allen Consulting Group 2007, Australia's National Saving Revisited: Where do we stand now?, A report to the Investment & Financial Services Association, Melbourne, pp. 33-34)

superannuation funds (maximum 15% on earnings), and the full tax deductibility of expenses of other investment earnings, when the return is not taxed in full due to the levy of CGT only on disposal of assets and the CGT discount.

Even if timing issues were fixed in relation to other investment earnings, such as by introducing negative gearing rules, the existence of the CGT discount or any other CGT tax benefit like indexation, would still make them more favourably taxed than bank deposits.

Even where negative gearing and CGT rules were changed to fully offset timing and other tax advantages, tax myopia may still lead investors to regard such investments as preferable simply because the tax seems to be deferred compared to the full current taxation of deposits.

The Architecture Paper noted that notwithstanding its comparable top personal tax income tax rate, Australia has a relatively high rate of tax on interest income compared with other OECD -10 countries (i.e. New Zealand, Netherlands, Spain, Japan, United Kingdom, Ireland, United States, Canada and Switzerland). It also noted that relative to interest bearing deposits, owner occupied housing, rental properties, listed shares and concessional (pre tax) contributions to superannuation are favourably taxed.

Some appropriate and targeted tax relief for domestic deposit products is necessary to address systemic bias against investing in bank deposits resulting in serious market distortions. Such relief would:

- reduce existing tax-based distortions between different classes of investments;
- restore an important and reliable funding source for Australian financial institutions, which is of self-evident importance in global credit crises, such as the present, where the availability of funding in wholesale markets is severely curtailed; and
- improve the low rates of national saving, in particularly, low household saving, which is a concern for retirement incomes.

The design of such measures is not a trivial issue if they are to meet their objectives without creating substantial compliance and administrative costs or integrity concerns. Nonetheless, overseas experience[7] demonstrates that many countries are responding to this policy issue and provides some guidance on design. For example, Canada recently announced the introduction of a special Tax Free Savings Account (TFSA) regime from January 2009. TFSA will have contribution limits of $5000 per annum and any unused contribution limit can be carried forward to future years. TFSA funds can be used for any purpose. Withdrawals from TFSA can be put back into the TFSA at any time.

There would be a number of product design options available in Australia. For example, consideration could also be given to an existing product, the Farm Management Deposit (FMD) scheme.

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[7] For example, see the OECD's 2007 Report: *Encouraging Savings Through Tax-Preferred Accounts*

FMD features include an upfront tax deduction for deposits (this would of course need to be capped to ensure affordability and targeting at appropriate income classes), tax on withdrawal, and tax at personal marginal tax rates on interest earned. To achieve the national savings and stability of financial systems objectives, a minimum term of deposit (say 4- 5 years) would be required.

This style of product has the advantage of allowing customers/investors to have access to a simple mechanism for managing their tax position, without engaging in speculative asset classes such as borrowing to invest in property or shares.[8]

There are other implementation options available, and Appendix 1 to this submission considers the policy issues in this important area in further detail.

4.4 Access to stable funding and capital: create 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

The ABA supports the retention of a dividend imputation system in Australia. However, a critical adjustment to the current framework is needed.

At present, Australian banks (and other Australian-based multinationals) face substantial obstacles in creating international businesses of scale. Under current tax laws, foreign-sourced income is generally not eligible for franking credits, as no Australian tax has been paid on it. This makes the shares of any Australian company with significant offshore operations less attractive to domestic tax-paying shareholders.

Truly international, but Australian-based, institutions would have an international shareholder base. At present, Australian banks and other Australian headquartered companies are required to co-mingle Australian-sourced and non-Australian-sourced income before distribution, which has the effect of channelling franking credits away from domestic shareholders to foreign shareholders (who have no use for them).

The reforms arising from the 2003 Budget and the Board of Taxation's Review of International Taxation Arrangements (**RITA**) Report, on which they were based, recognised that Australia should not claim any tax on foreign source income that flows through Australian entities to non-residents (i.e. "conduit income").

Current policy, however, is based on the view that income of a company belongs equally to all shareholders so that foreign shareholders are treated as entitled in part to the foreign income and in part to the Australian income of Australian companies (the proportional approach). This policy is enforced by a large number of anti-avoidance rules that cause significant compliance and other costs as discussed further below. Moreover, there is a well recognised and permitted exception to the proportional approach policy and rules in the form of dual listed

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[8] By way of example, for the current limited eligible class of taxpayer who are able to utilise the FMD scheme, as at June 2008, there were 41 355 account holders, with $2.9 billion held in 12 month accounts. This demonstrates a customer acceptance of the scheme and an understanding of its benefits. Further, current bank systems and reporting processes accommodate a product of this nature, so implementation costs are minimised.

companies which effectively match foreign income of an Australian multinational with its foreign shareholders.

The effect of the existing rules is that there is a tax bias in the current system to expand overseas via a dual listed structure, even if that is not the most economically efficient way to do so (and in the case of banks, this structure would certainly raise significant regulatory issues in at least Australia and probably also the other host jurisdiction). It is evident from the current international credit crisis that there will be significant consolidation of the banking sector internationally – indeed the process is now in train. Banks based in other countries are not constrained by their tax systems in entering into international takeover or merger transactions in the same way as Australian banks which places Australian banks at a competitive disadvantage.

The dual listed issue is part of a broader systemic bias in the current system that needs to be addressed. One of the main policies underlying the proportional approach is that Australia should operate at the shareholder level on the basis that foreign income is taxed on a basis equivalent to getting a deduction for the foreign tax (which is the outcome of the current interaction of Australia's imputation system and the treatment of foreign taxes at the Australian corporate level). That is, Australia operates a system of national neutrality rather than capital export neutrality at the shareholder level. The justification generally advanced by the Australian Treasury for this approach is that Australia receives no benefit from the payment of foreign taxes whereas Australia overall benefits from the payment of Australian taxes. Hence it is argued that the correct policy setting is that investment overseas should only occur when the post-foreign-tax rate of return exceeds the pre-Australian-tax rate of return on an alternative domestic investment, as foreign investment will only then occur when Australia overall is better off.

It is suggested that this policy view overlooks the asymmetric treatment of losses compared to profits. If a higher pre-tax rate of return is required for foreign investment, it is axiomatic that such investment will be riskier (in addition to the inherently more risky nature of foreign investment because of information issues for Australian investors in foreign markets).

It follows that there is greater likelihood of loss on such investments. Normally that loss will show up in full in Australia's tax system rather than in the foreign tax system.

This can occur in a variety of ways but the simplest example is if an Australian parent company acquires a foreign subsidiary which it sells at a significant loss because of losses in the subsidiary. The change of control will mean in many countries that the subsidiary's losses will be denied to the subsidiary in the foreign country even though its profits would be taxable there. Accordingly, the sale price of the subsidiary will not reflect any payment by the buyer for the tax benefit of the losses and the full loss is borne by the Australian tax system through capital losses or smaller capital gains at the shareholder level (assuming the loss is not allowed at the Australian corporate level because of the CGT participation exemption).

The current international environment demonstrates only too clearly that massive losses on assets in one country, e.g. US sub-prime mortgages, are borne in full by foreign owners of the assets (and hence generally by the tax systems of such owners).

There is a variety of mechanisms by which this systemic issue can be addressed. The Board of Taxation proposed in 2003, and the Government rejected "for the time being", granting imputation credits on a notional basis for foreign income.

The ABA instead recommends that existing legislation be amended to allow overseas shareholders to receive dividends from profits generated overseas, without the attachment of Australian franking credits and free from Australian dividend-withholding tax and requirements to co-mingle foreign and domestic revenue streams.

There should be no integrity concerns with such a proposal (as may have existed with the 2003 proposal) while the holding of foreign assets is a smaller percentage of a company's assets than its percentage of foreign shareholders. The nature of international investment and the operation of capital markets mean generally that most multinationals have a greater local shareholding base than they do foreign assets.

4.5 Certainty and simplicity: 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

Architecture makes is abundantly clear that Australia is burdened with a very complex tax framework, with many taxes that raise comparatively little revenue, but with high compliance costs.

Three key reforms are needed.

Reduction/abolition of State taxes

First, there should be a significant reduction in the sheer number of different taxes paid by Australian businesses, by eliminating minor taxes while adjusting the others to maintain taxation revenue at its current levels. This will reduce compliance costs of operating in Australia and make it a more attractive destination for overseas business. The taxes which are of greatest concern because of their negative effects on economic efficiency and complexity are stamp duties on business transactions and payroll taxes.

A realistic goal and outcome of the Review is the abolition of all stamp duties on business transactions in the short to medium term. Ideally, payroll taxes would be abolished as well, however the ABA accepts that the revenue impact of such a move would be considerable and the immediate preference is to target the elimination of business stamp duties.

The potential gains from the reform of State taxation are large and rival the gains derived from past microeconomic reforms. The Australian economy has benefited significantly from microeconomic reforms of, especially, the 1980s and 1990s. However, the benefits of the past reforms are starting to wane as evidenced by the slowing in productivity growth in recent years. The establishment of new reform agendas would help to reinvigorate productivity growth.

Research undertaken earlier in 2008 on behalf of the ABA and other finance sector bodies[9] indicated that State tax should be included on any such reform agenda. Net benefits each year to economic welfare in the long-term of between 1% and 2%, the equivalent of $6 to 10 billion to household consumption, were indicated as being possible.

There are sizeable benefits for the States if they act unilaterally to shift their tax base away from as heavy reliance on stamp duties as is the case today. While their revenue bases are relatively narrow, the States do have scope to shift the mix of taxation towards a more efficient structure, possibly involving the replacement of stamp duties on at least business to a heavier reliance on land-related taxes. (The latter should exclude capital improvements.)

There are sound reasons for a more comprehensive approach to the reform of State taxes including the involvement of the Commonwealth Government[10]:

- First, Commonwealth revenues would be directly boosted by any improvement to economic efficiency that accrues from the reform of State taxation. For the policy options considered in the earlier research, Commonwealth revenues could be increased by between $1.6 billion and $4.7 billion a year, depending on the scenario, thereby providing increased funds that could be applied to helping to make the reforms revenue neutral.
- Secondly, the Commonwealth Government has recognized that many future microeconomic reforms will require the intimate involvement of the States if they are to be successful. The further reform of State taxation is one area where the national benefits are large and where policy options involving the Commonwealth and States operating together are achievable. Reform in this area could assist in delivering reforms in other, potentially more difficult, areas.
- Thirdly, as has been seen over recent years, the Commonwealth revenues tend to benefit more from windfalls associated with stronger economic conditions than do State revenues. There would be merit in earmarking at least part of future windfalls to the reform of State taxation.

In any such reforms, a range of policy objectives will need to be considered including the impact on equity (across individuals and households) and the simplicity of the system both for the perspective of administers and, especially, compliance. Nevertheless, the benefits to economic efficiency indicate that the task is worthwhile.

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[9] See the April 2008 report "Analysis of State Tax Reform" prepared by Access Economics for the Financial Industry Council of Australia ("**FICA**"), of which the ABA is a member: http://www.bankers.asn.au/ArticleDocuments/AE-FICA%20Final%20April.pdf.aspx

[10] See the April 2008 report "Analysis of State Tax Reform" prepared by Access Economics for FICA: http://www.bankers.asn.au/ArticleDocuments/AE-FICA%20Final%20April.pdf.aspx

Harmonisation of rules for State taxes

Secondly, legislation for all remaining State/Territory taxes should be harmonised. That is, the legislation should be identical in all respects (e.g. tax base, definitions, exemptions and collection procedures), with the possible exception of tax *rates*. In an ideal world, rates would be identical. However, the ABA accepts that States/Territories, with their own budgets/spending needs may require autonomy in this respect.

Together these changes will significantly reduce compliance costs for financial institutions in Australia and make it a more attractive destination for overseas business in the finance sector as well as generally. They will also contribute to making Australia a strong financial services centre.

Single Australian revenue authority

Thirdly, there should be a single revenue authority, where the ATO would administer/collect all Federal and State taxes. A business taxpayer (large or small) could lodge a single BAS statement covering all of its Federal and State tax obligations.

It is remarkable, and highly costly, that a nation of only 21 million people has nine separate tax administrations, each with their own (different) rules, regulations, forms and processes. In effecting this change, administrative difficulties in current tax administration and improvements in the performance of the ATO should also be addressed.

4.6 Certainty and simplicity: 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

Two of the main causes of currently very high compliance costs for business taxpayers, and especially banks, are the multiplication of anti-avoidance rules and their administration in ways which are inconsistent across time and without regard to business realities.

Removal of anti-avoidance rules

The ABA accepts that anti-avoidance (or "integrity") measures are a necessary part of any tax law. Unfortunately, layers of specific anti-avoidance rules now exist (particularly in the income tax law) in addition to general anti-avoidance provisions.

The existence of so many specific anti-avoidance rules adds significantly to the overall complexity and uncertainty of taxation law and hence to compliance and administration costs as well as efficiency costs.

It should not be thought that such rules only affect taxpayers who are 'playing games' with the tax system; that anti-avoidance rules have no significance except for taxpayers who are 'sailing close to the wind.' Rather, because the rules are so profuse, so all-encompassing and so obscurely drafted, taxpayers cannot be sure that their activities will not fall foul of some rule or other.

Many "mainstream" transactions require time-consuming, lengthy and costly private and public rulings from the ATO prior to implementation. This is stifling for legitimate business and investment activity. It is especially problematic for foreign taxpayers seeking to establish operations in Australia who find that they have to exercise what they regard as excessive caution and seek clearance for relatively simple transactions.

Further, some of the current anti-avoidance rules are very punitive and/or restrictive in that they have operation when a taxpayer has a purpose other than of an incidental nature of obtaining a tax benefit – in comparison to the (more reasonable) "sole or dominant purpose" found in the general anti-avoidance rule.

It is time to remove a number of the specific anti-avoidance provisions, particularly those rules having application to franking and debt/equity matters, e.g. sections 177EA, 204-15, 204-25, and 204-30.

Where necessary, some appropriate amendments could be made to the general anti-avoidance rule so as to ensure that all possible perceived tax benefits are within its ambit, in accordance with the standard "sole or dominant purpose" test, as has been done for tax benefits in relation to capital losses (s.177C(1)(ba), foreign income tax credits/offsets (s.177C(1)(bb), and withholding tax (s.177CA).

Consistent and balanced administration of tax law, especially anti-avoidance rules

We need to move away from a "chase every last dollar" mindset which pervades the current tax law and its administration. This approach produces large deadweight costs for the community which need to be eliminated or at least substantially mitigated in Australia's future tax system.

Australia has recently recognised in its tax treaty policy that it needs a more balanced approach between source and residence taxation, though this has not yet permeated its way into tax administration practice. The same world view should be applied more generally, as it is in many other countries. Australia is an important player on the world investment stage in a number of ways and no longer just an in-bound destination that needs to protect its revenue base.

If a tax administration is overly aggressive with in-bound investors, it will almost necessarily be similarly aggressive with local companies. The general approach of the tax administration in most major OECD countries is much more taxpayer-friendly than it is in Australia, in recognition of the fact that if business can work cooperatively with the tax administration, then business will be better off and the country will also be better off. The benefits to local business of a more cooperative approach are significant, especially in terms of certain and simplicity, and reducing current barriers to normal commercial transactions. Additionally, making Australia a more friendly tax environment for foreign investors will also contribute to further improving our financial services centre credentials.

The recent review of tax law design has recognised the needs for business involvement from the outset and to enact practical measures which accord with business realities. It was not the purpose of that review to consider the interpretation and administration of legislation after enactment, though monitoring was recommended. In the ABA's view the time has come to look at the issue of interpretation and administration from a similar perspective.

Unfortunately there is currently a perception in the business community that the stance of the ATO is becoming more aggressive and inconsistent both generally and on anti-avoidance rules. This is manifested in a variety of ways, such as changing previously held ATO views in relation to private ruling requests on the operation of anti-avoidance rules, longer delays in getting private rulings, highly controversial public rulings and discussion documents and increasing confrontation and litigation with large business taxpayers. Examples include transfer pricing and financial arrangements, OBU provisions, key debt/equity provisions and ADI thin capitalisation provisions. With some current issues of interpretation, it is acknowledged that there are alternative arguments but there has been an increasing tendency for the ATO to adopt the view which produces the most tax, notwithstanding potential conflicts with policy intent and commerciality.

As noted earlier in this submission, this discussion of anti-avoidance rules is part of a larger issue of ensuring that the applicable government policy is clear and that the law is clearly framed in terms of that policy.

In the view of the ABA, consideration should be given to mechanisms that can address these problems on an on-going basis. One approach may be to give the ATO the express power to relax its view of the law in favour of the taxpayer in appropriate commercial circumstances (compare the care and management power in New Zealand and UK extra-statutory concessions). There should also be an on-going process to keep the tax law up to date in view of technical and market developments in line with the recent recommendations on the tax design process.

We attach at Appendix 2 a case study on the issue of convertible preference shares. This case study reflects the high level of complexity and uncertainty in the current tax law for a fairly standard transaction, which arises through a combination of multiple anti-avoidance provisions and concerns about interpretation and administration of the tax law by the ATO.

4.7 International competitiveness, certainty and simplicity: implement structural changes to GST: GST-free treatment of all financial supplies; or, GST-free treatment of B2B financial supplies

A number of areas for GST structural reform in relation to financial services should be considered by the Review.

The traditional and still core, function of the financial services sector is to serve as an intermediary between lenders and borrowers. As such, from an economic standpoint, financial intermediaries provide the means to consumption. That is, in simple terms, banks and other financial institutions allow customers the means by which they can consume goods, other assets and services.

It is well known that the current GST regime, with an "embedded" GST in the financial sector, effectively causes a double tax on consumption, as consumers bear embedded GST on the cost of finance in addition to GST on the underlying goods or services consumed. That is, the approach of "input taxing" or exempting financial services is a distortion on the pure VAT model.

The design of the GST regime is that it "is effectively a tax on final private consumption"[11]. As financial services are the *means* of end-consumption, they should not bear embedded GST from an economic standpoint. The imposition of such a tax is economically inefficient and distortive to the intended design of the GST system due to the cascading effect.

The reason that financial services have been historically input-taxed in VAT/GST regimes is that the value provided by the financial intermediary has been difficult to calculate as the consideration for the service is wrapped up in the gross flow of funds. However, the approach of input-taxing or exempting financial services is a distortion on the pure VAT model in the "business to business" (**B2B**) context as the businesses are not able to recover the embedded GST included in the financial services they acquire and which form part of the cost base to which GST is later applied. That is, this leads to distortions (cascading) and economic inefficiencies as businesses are not able to recover the embedded GST included in the financial services they acquire.

Thus far, different countries have recognised this design flaw and have attempted to address it by applying various 'solutions' to the problem. For example, the current Australian system has limited what supplies are regarded as 'exempt' or input-taxed and provide a wider regime for claiming back GST to banks. The approach in New Zealand is viewed as more 'ideal' from an economic perspective as it eliminates the GST/VAT on financial services by zero-rating B2B financial supplies.

There have been further moves for reform in the European and Asian context in terms of improving competitiveness through examining areas of tension such as the definition of exempt services, cascading of VAT in the B2B context and apportionment of VAT for banks.

Zero rating of B2B transactions will alleviate distortions to investment, savings and will aid simplification. Such measures should also improve Australia's competitiveness as compared to jurisdictions such as Hong Kong, Singapore and New Zealand and enhance Australia's role as a financial services centre.

Further, the Review should examine zero rating "business to consumer" (**B2C**) transactions. GST is meant to be a tax on consumption, not on saving, nor the return to saving. If a bank charges an account-keeping fee (such fees are input-taxed and thus liable to tax indirectly) the effect of the fee is to drive down the return to the customer, but it is not self-evident that the customer should be treated as a consumer of a service or as a saver whose return has been reduced.

Using the expenditure tax base (p. 332 of Architecture) it is not self-evident whether a bank fee should be treated as reducing S_t or C_t.

At the very least, the ABA recommends that one outcome of the Review should be a detailed economic study of reform to the treatment of financial services within the GST system.

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[11] Executive Summary to the Consolidated Explanatory Memorandum to the A New Tax System (Goods and Services Tax) ACT 1999.

That study should not only consider/model zero-rating B2B financial services but also, more broadly, the potential for a GST free treatment for *all* financial supplies.

Appendix 1

Stabilising Bank Funding through Tax-preferred Accounts

KPMG Econtech

The ABA commissioned KPMG Econtech to undertake preliminary research on the economic case for the implementation of a tax-preferred bank accounts scheme. Many OECD countries use tax-preferred accounts to improve on low rates of national saving (OECD, 2007). This is of particular concern given the low level of household saving and the implications this has on people's retirement savings (Allen Consulting Group 2007). However, given the current global financial crisis, the ABA requested that this preliminary research focus mainly on the macroeconomic risks that arise when an unattractive tax environment for bank deposits erodes the bank deposit base, leaving the banking system heavily dependent on less reliable wholesale funding.

Close attention is now being given to the balance sheets of our banks. On the assets side, bad debts, while rising, are still low compared with other advanced countries. On the liabilities side, Australian banks have become heavily dependent on wholesale funding to supplement their deposits base (IMF, 2008), and rolling over this wholesale funding has become more difficult as part of the financial crisis. Failure to rollover wholesale funding for a significant period would severely restrict lending, hitting the economy hard. This vulnerability has led the Rudd Government to announce on 12 October that, as one of three new measures to maintain the stability of the financial system, it will guarantee the term wholesale funding of local banks until global financial markets stabilise.

The breathing space provided by this short-term solution to the funding vulnerability provides an opportunity to devise a long-term solution. One reason for the current situation is that foreign wholesale funding of local banks is one means by which Australia's high current account deficit is financed. But another important reason is that bank accounts have a less favourable tax treatment than the main savings alternatives available to households, such as superannuation, shares and property. This has weakened the bank deposit base, lending to high reliance on wholesale funding of bank lending. In recent years the bank loan to deposit ratio in Australia has fluctuated between around 110 to 120 per cent, well above the international norm for advanced economies of about 90 per cent.

Heavy reliance on foreign wholesale funds has also weakened the nexus between the official cash rate and bank interest rates. The gap between interest rates for bank lending and the cash rate set by the Reserve Bank has widened considerably as the cost of foreign wholesale funds has soared on the back of global financial uncertainty.

Many OECD countries use tax-preferred accounts for the more general reason of improving on low rates of national saving (OECD, 2007). This reflects a general concern that taxation of interest may impair economic efficiency by discouraging saving. Besides economic efficiency, the other important principles in assessing any taxation proposal are its effects the equity and simplicity of the tax system, as well as its cost to the Federal Budget.

The terms of reference for the Review reflect the same accepted taxation principles. In particular, they include consideration of the enhancement of the taxation of savings, assets and investments (Terms 3.3) and the need to ensure appropriate incentives for individuals to save and provide for their future (Terms 4.2). The terms of reference also include consideration of equity (horizontal, vertical and inter-generational) (Terms 2).

But the current financial crisis brings into sharp relief the potentially severe macroeconomic consequences of the unattractive tax environment for bank accounts – our banks have had to become highly dependent on foreign wholesale funding which has now become less reliable.

IMF Analysis of Funding Vulnerability

The IMF (2008) has identified two vulnerabilities of Australia's banking system to the global financial crisis. "The first is the rollover risk, related to banks' reliance on wholesale funding, a large fraction of which is short term."

In assessing this rollover risk, the IMF's finds that:

- "Australian banks rely heavily on wholesale funding";
- "a significant share of wholesale funds are short-term"; and
- a stress testing simulation "highlights the dependence of Australian banks on a stable international funding environment".

In commenting on the heavy reliance on wholesale funding, the IMF (2008) observes:

> "Wholesale funds (domestic and offshore) account for about 60 percent of total funding of the banking system, and more than 40 percent of wholesale funds come from offshore. A significant increase in banks' reliance on wholesale funding occurred in the 1990s, driven by the combination of strong credit growth and an erosion of banks' traditional retail deposit base, which was due in large part to the shift in household financial assets to superannuation funds. This funding structure is predicated on banks maintaining high credit ratings and carries foreign exchange, interest rate, and liquidity risk (although the foreign exchange and interest rate risks have mostly been hedged)."

Its comments on the short-term nature of wholesale funding are as follows.

> "About 30 percent of total offshore funds of Australian banks have residual maturity of less than one year. This ratio is close to 45 percent for small banks. Domestic wholesale funding is predominantly short-term, with about 75 percent of funds having residual maturity of less than one year. This funding structure makes the banks dependent on a stable international and domestic funding environment, and leaves them vulnerable to increases in the cost of funds and to the protracted loss of access to international short-term debt markets."

From the stress tests it reached the following conclusion.

> "Australian banks need to constantly roll over large amounts of foreign debt. For the purpose of stress tests, it was estimated that foreign debt of all banks with residual maturity of less than 90 days is around $A 220 billion ($A 160 billion for the four large banks). While this likely overestimates the true amount, given the conservative assumptions, it implies that the amounts that need to be rolled over every three months are large, equivalent to around 20 percent of GDP. This highlights the dependence of Australian banks on a stable international funding environment, which in current circumstances cannot be taken as a given."

Australian Banks' Liabilities

(per cent of total)

	Dec-04	Dec-05	Dec-06	Jun-07	Dec-07	May-08
Deposits (ex CDs)	44.1	44.2	42.4	42.6	40.0	40.6
Household	20.4	20.0	18.5	17.2	16.3	16.6
Business	13.9	13.8	13.8	14.0	13.3	12.6
Intra-group	3.4	3.7	3.0	3.1	4.1	4.8
Domestic wholesale	28.7	28.7	29.8	30.7	34.6	34.0
Offshore	27.2	27.1	27.8	26.7	25.4	25.4
Total liabilities	100.0	100.0	100.0	100.0	100.0	100.0

Source: IMF (2008)

Existing Tax Treatment

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. The tax rate on interest earned on savings accounts is also much higher than the tax rate for other savings vehicles, such as superannuation, shares and property.

The current tax treatment of bank deposits is to tax interest earned at the normal income tax rate, meaning that deposits have a relative tax disadvantage compared to other savings vehicles, particularly superannuation. Not only is the interest earned on these accounts taxed at a higher rate, but the tax is levied on the full interest earned rather than the after-inflation interest.

Bank Deposits

- Income deposited is taxed at the marginal income tax rate.
- Interest earned is taxed at the marginal income tax rate.

Superannuation

- Employer contributions of up to $50 000 per year are taxed at only 15 per cent.
- Income earned on super investments is taxed 15 per cent (and capital gains at 10 per cent).

Shares and Property

- There is a 50 per cent discount on personal income tax payable on capital gains from shares and property, provided the asset is held for more than 12 months.

In the past these tax advantages of superannuation were limited and partly offset by a tax regime for superannuation lump sum benefits. However, from 1 July 2007 this changed and benefits are now tax free, subject to certain conditions, including that the income is received from a taxed source and the individual is over 60 years of age. This tax treatment of superannuation represents sound public policy because it provides an appropriate incentive for individuals to provide for their own living expenses in retirement, rather than rely on the age pension.

At the same time, from these details, it is clear that savings put into bank deposits are taxed at a much higher rate than are savings put into superannuation funds. For individuals receiving average earnings in 2008/09, the marginal income tax rate is 30 per cent. Hence, any savings deposited into a term deposit are taxed at 30 per cent, as is the interest earned on that deposit. However, if that same individual instead deposited those savings into their super fund, the taxation rate applied, on both contributions and income earned, is 15 per cent.

At the same time, it is recognised that superannuation and bank deposits are not completely comparable savings vehicles. Deposits in bank accounts can be withdrawn at a time that suits the individual, subject to certain requirements if the savings are in a fixed term deposit. However, savings put into superannuation funds are illiquid since it is difficult to withdraw the funds before the individual reaches the preservation age. Savings put into superannuation accounts cannot be withdrawn before preservation age is reached unless the individual meets certain criteria such as total and permanent disablement or is enduring financial hardship.

Even taking this into account, the effective taxation on interest earned on bank deposits is still high. The notion of economic income implies that tax should only be applied to interest earned after it has been adjusted for inflation. That is, tax should only be applied to that portion of income that provides a return above the inflation rate. Instead, in reality, the full interest earned on bank deposits is taxed at the marginal income tax rate, and there is no tax concession for the erosion of interest earnings from inflation.

Taking a simple example, if an individual earning an average income held a 12 month term deposit receiving an interest rate of 7 per cent, and if in inflation is, say, 3 percent, they will receive 4 percent as net income. If tax is then applied to the 7 per cent interest at a marginal rate of 31.5 per cent (including Medicare levy), the individual will pay 2.2 per cent in tax. This leaves the individual with a net real return of 1.8 per cent on their term deposit. Thus, the effective real tax rate for this individual is approximately 55 per cent (=2.2/4.0), not 30 per cent. If instead an individual in the highest income tax bracket were to hold the same term deposit, their effective marginal tax rate is 81 per cent.

It is not been suggested that inflation accounting should be introduced in the taxation of bank interest. However, the very high effective tax rates that arise from lack of inflation accounting can be addressed by lowering headline tax rates. This is the same type of approach that is adopted in applying personal income tax to capital gains. Indeed, the 50 per cent discount was introduced in place of a previous inflation accounting regime.

These very high effective tax rates are likely to be one factor behind the high loan to deposit ratio of Australian banks.

The OECD report *Encouraging Savings through Tax Preferred Accounts* reviews the international experience of tax preferred accounts. It concludes that tax preferred accounts create new savings when moderate-income households participate in them. In many cases, low-income households are less likely to take up such accounts. However, the UK has been successful in ensuring the participation of many low- and middle-income households.

Design Options

One option would be to introduce a tax-preferred account with 15 per cent tax on interest income, similar to the newly-introduced first home owner saver accounts.

This narrows the gap with superannuation, with its 15 per cent earnings tax, and 10 per cent capital gains tax. Super would continue to have the advantage of only a 15 per cent contributions tax on entry, whereas bank deposits are made after personal income tax has been deducted from pre-tax incomes. This recognises the stricter preservation requirements of superannuation.

A 15 per cent tax rate for tax-preferred accounts would also be more consistent with the tax treatment of capital gains. For an individual on the 30 per cent marginal tax rate, a 15 per cent tax rate for tax-preferred accounts achieves a similar result to the 50 per cent discount on capital gains.

An element of preservation could be introduced to the tax-preferred account by limiting them to term deposits. They could have a minimum term of, say, four years. A lower minimum term could be contemplated given that a holding period of only 12 months is required to access the capital gains tax discount.

The progressive nature of Australia's income tax regime means that the federal budget impacts of a tax-preferred bank accounts scheme will depend on whether low or high income households are more likely to participate.

For example, if a flat tax of 15 per cent is applied to all interest earned on term deposits, the government will lose more tax revenue if a high-income individual takes up that term deposit than if a low-income individual takes it up. Also, the greater the initial household savings, the greater the foregone revenue will be from lowering the interest tax rate. Thus, for a more efficient scheme (greatest increase in term deposits for the least cost), the design should be such that it encourages the participation of low- and middle-income households.

However, OECD (2007) compiles evidence from overseas that participation rates in such savings accounts increase as incomes increase: that is, rich people are more likely to utilise tax preferred bank accounts, as can be expected because of their high marginal propensity to save.

However, for some countries, such as the UK and Italy, governments were able to encourage significant participation from middle income households in order to mitigate the high participation by richer households. For example, the UK has a variety of accounts in which earnings from the funds deposited are tax free, but most accounts have tax penalties for early withdrawals. The UK government also offers low income earners bonuses when they contribute to certain savings accounts.

To mitigate the budgetary implications of high participation by high income households, KPMG-Econtech recommends that a cap be placed on the interest earnings that can receive the concessional tax rate. Interest earned above this threshold should be taxed at a higher rate. This would encourage savings in the low- and middle income sections of the community who have less capacity to invest in other more restrictive or risky savings vehicles such as shares, property trusts, and long term superannuation.

Likely Benefits and Further Research

The key benefits of the tax-preferred accounts idea, incorporating preservation requirements and caps on benefits, are as follows.

- The Australian economy would be less vulnerable to international financial shocks because of reduced reliance on foreign funding of the banking system.
- The Reserve Bank would be able to operate monetary policy more effectively as reduced reliance on foreign funding would tighten the relationship between the domestic cash rate and bank lending rates.
- The efficiency of the tax system would be improved because tax-preferred accounts would narrow the gap in tax treatments with more tax-preferred forms of saving such as superannuation.
- OECD (2007) research suggests that a well-designed tax-preferred accounts scheme can contribute to national saving.
- Increased household savings may improve the retirement savings gap for households, thereby raising people's retirement living standards.
- A cap on tax-preferred interest income could be imposed to promote equity and contain the cost of the measure to the Budget.

Further research would analyse these issues in more detail and quantify findings where possible.

References

OECD (2007), Encouraging Savings through Tax-Preferred Accounts, OECD Tax Policy Studies No. 15, OECD Publishing.

IMF (2008), IMF Country Report No. 08/311, Australia: Special Issues.

Appendix 2

Case study on complexity and anti-avoidance measures: issues of convertible preference shares

In recent years, many Australian corporations (and especially banks) have issued convertible preference shares (**CPS**) as part of their overall capital funding and management initiatives.

CPS are relatively simple financial instruments – being preference shares which carry a fixed dividend for a period and which will usually convert into ordinary share capital of the issuer after a specified period or upon the happening of specified events. The shares are typically not part of any other "stapled" instrument, do not involve interposed entities or special purpose vehicles and generally have no cross-border elements unless the shares are subscribed for by a non-resident. That is, the CPS would typically be offered by the Australian operations of the issuer and not through a foreign branch or subsidiary.

How hard should it be to ascertain the tax treatment of such a straightforward transaction for the issuer and the investors?

Despite the relatively unremarkable and simple nature of CPS, issuers have generally found it desirable and even necessary to approach the ATO for not one but two rulings: a private ruling on the implications of the CPS for the issuer and a class ruling for the benefit of the investors.

The main reason for the need to seek such rulings is the overall complexity of the tax law applying to such transactions and in particular the number and width of the various specific anti-avoidance provisions.

Consider the case of CPS issued by Suncorp-Metway Limited (**Suncorp**) pursuant to a prospectus dated 14 May 2008.

The ATO issued Class Ruling CR 2008/57 (**Suncorp Class Ruling**) on 10 September 2008 as regards the tax implications of the Suncorp CPS for investors. (The fact that the ATO's practice to date has only been to issue class rulings after (and sometimes well after) a financial product has been offered/subscribed for by investors is itself a problem, although it is noted that the ATO is planning to issue class rulings under the "priority" system which until now only applied to private rulings.)

The Suncorp Class Ruling runs for 30 pages and is likely to be regarded as highly impenetrable to most investors it seeks to enlighten, given the complex subject matter and range of issues which it has to address.

Some further "statistics" about the Suncorp Class Ruling:

- the ruling provides the ATO's view on no less than 16 different tax issues/aspects of the Suncorp CPS and in so doing considers 12 individual sections of the Tax Act and in addition 5 Divisions or Subdivisions thereof. (There are in fact references to *89 different legislative provisions* once regard is had to subsections and paragraphs);

- six of the provisions/Divisions etc considered, which occupy a disproportionate amount of the body of the ruling, deal with specific anti-avoidance measures, mostly referable to the imputation system (i.e. sections 45, 45A, 45B, 177EA, section 204-30, and former Division 1A of Part IIIA of the 1936 Act (which, somewhat bizarrely, remains active notwithstanding its repeal due to some convoluted and contentious deeming rules));
- there are 16 assumptions upon which the ruling is based which in theory would need to be considered/understood by investors/readers. As is generally the case with other class rulings issued by the ATO, it is not self-evident that some of the assumptions are accurate unless the investors/reader approached Suncorp for confirmation; and
- the ruling states that it only applies to certain types of investors and even in such cases specifies a whole range of situations when it will in any event not be applicable.

The fact that such a complex ruling is needed to deal with such a relatively simple financial transaction is clear evidence that the income tax rules generally (and the specific anti-avoidance rules in particular) have become far too complicated and indeed are veering out of control, even before consideration is given to the time and costs for business of seeking rulings of this nature.