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OVERVIEW CONTENTS

Introduction 9

A business tax system for Australia's future 9

Background to the Review 10

The Review's approach to the task 11

Objectives of the Review 13

Optimising economic growth 13

Promoting equity 15

Promoting simplicity and certainty 16

Effective community participation 17

The revenue constraint 18

A growth dividend 19

A compliance dividend 22

Revenue trade-offs 23

Impact of the Review's recommendations 28

Accelerated depreciation/company tax rate trade-off 29

Compliance costs 31

Impact on businesses 32

Impact on small business 33

Impact on investors 33

Summary 34

KEY RECOMMENDATIONS

Building a strong foundation 34

Policy formulation 34

Legislation 36

Administration 36

A durable framework for income taxation 37

Reinforcing integrity and equity 46

Applying a cashflow/tax value approach 54
Capital allowances 54
Financial assets and liabilities 57
Leases and rights 60

Implementing a unified entity regime 62
Imputation 63
Distributions 65
Life insurance and pooled superannuation trusts 67
Consolidated groups 70

Recognising direct investors and small business 72
Flow-through taxation 72
Small business initiatives 74

Rewarding risk and innovation 77
Incentives for investing 76
Capital market incentives 78

Responding to globalisation 79
Australians investing offshore 80
Foreign investment in Australia 82
Allocating income between countries 82
Improving Australia's international taxation regime 83

Introduction

A business tax system for Australia's future

Australia needs a sound tax system to support economic growth in a globalised world

1 Australia needs a sound tax system to contribute to the improvement in the future living standards of all Australians. It must be capable of dealing with a changing world environment, changing technology and changing lifestyles. It must also provide enough revenue to ensure that essential Government services are available to all Australians.

2 A sound tax system has to be about raising revenue in an equitable and efficient manner. It has to be about economic growth and international competitiveness. It has to reward hard work, innovation and measured risk taking. Such a tax system will help ensure that Australia has an internationally competitive economy so that Australians can enjoy improved living standards.

3 The increasing globalisation of the world economy, driven largely by technological change, means that economic activity can flow more readily than in the past to the most efficient and low cost locations. Increasingly Australian businesses will be world businesses and it is essential for Australia's future that Australians have the opportunity to own and work in successful businesses in that environment. This means that the business tax system must operate effectively and competitively in that environment.

Business taxes are needed to help fund Government expenditures in the context of increasing community expectations and changing demographics

4 The Review has been conscious that business taxation plays a significant part in raising the revenue necessary to fund the provision of Government services. The revenue neutrality constraint in the terms of reference means that the Review's recommendations in total will have to maintain current levels of business tax revenue. However, it is important that the resultant tax system is not only revenue neutral in the short term but ensures that the business tax system continues to make an appropriate contribution to funding Government services over the long term.

5 The community expects governments to maintain a strong and sustainable social safety net. Increasing community expectations and demographic change are likely to place significant pressure on health and social welfare expenditures. Reform of the tax system is an essential step in ensuring that Australia generates the resources to meet these aspirations and requirements.

6 Australia is undergoing a significant demographic transition associated with lower population growth and reduced mortality rates. Between 1997 and 2051 the population aged over 65 years is expected to rise rapidly. As a proportion of the total population this group increases from about 12 per cent in 1997 to 18 per cent in 2021 and around 26 per cent in 2051[1]. Based on demographic trends and historical growth rates, the National Commission of Audit Report in 1996 estimated that total health expenditure will increase by 6.1 per cent of GDP and that the age pensions will increase by 1.1 per cent of GDP by 2031[2].

Background to the Review

The Review was to take as its starting point the proposals outlined by the Government in *A New Tax System*

7 The Government announced its overall tax reform strategy with the release on August 13, 1998 of the document, *Tax Reform, not a new tax, a new tax system,* known as *A New Tax System*. *A New Tax System* outlined a strategy for business tax reform and some specific reforms relating to the taxation of income from entities.

8 The Review of Business Taxation was set up to examine the strategy specified in *A New Tax System*, and to consult on the framework of reform for taxing business entities and on the extent of reform for taxing business investments, recognising the current problems and the objectives for business tax reform identified in *A New Tax System*.

9 The Review has been conducted based on the Government's proposals outlined in *A New Tax System,* incorporating the policy directions adopted by the Government in that document, and in accordance with the terms of reference.

10 Some points of particular note emerge from the terms of reference.

- The Review was asked to make recommendations on the fundamental design of the tax system, the processes of ongoing policy making, drafting of legislation and the administration of business taxation.
- Consultations by the Review and associated recommendations were to be directed to the strategy for reform spelt out in *A New Tax System*.

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1 Australian Bureau of Statistics (1998a) *Population Projections 1997-2051,* ABS Cat No 3222.0, Canberra.

2 National Commission of Audit (1996) *Report to the Commonwealth Government,* AGPS, Canberra.

- The Review was required to have regard to developing an internationally competitive tax treatment of business investments, the potential benefits of bringing tax value and commercial value closer together, and the possibility of achieving a 30 per cent company tax rate.
- The Review was asked to consider specific options for reform of capital gains tax.
- Importantly, the Review's recommendations were to be revenue neutral in respect of reforms to investment and capital gains tax.

The Review's approach to the task

A high level of community involvement has been essential

11 The Review has sought to promote a high level of community involvement in all its processes. The strategy has been to publish issues papers which provided background information and analysis of issues that were identified by the Review and to seek community reaction to those issues. This community response has then suggested further analysis and has been taken into account by the Review in reaching its recommendations.

The Review published issues and information papers, sought submissions, and conducted extensive public consultations through a range of forums

12 The Review's first discussion paper, *A Strong Foundation,* provided some basic information about the deficiencies in the current business tax system and set out some possible principles that could be used to underpin the policy, legislative and administrative development of the business tax system. The paper also canvassed possible reforms to the way the tax system is developed and maintained, including:

- a more open and transparent development of tax policy;
- a more integrated design process; and
- much more extensive opportunities for consultation on all aspects of the tax system.

13 Following the release of the paper, the Review conducted an extensive range of public seminars covering all capital cities and sought submissions from the community. There were 76 submissions received relating to the issues canvassed in *A Strong Foundation.* Details of these are set out in Appendix B.

14 The next publication by the Review was an information paper commissioned by the Review, *An International Perspective,* which provided detailed information on international practice in respect of a wide range of business tax issues.

15 The Review's second discussion paper, *A Platform for Consultation,* provided a detailed analysis of the full range of issues before the Review and canvassed a range of policy options in respect of particular issues.

16 The release of this paper was followed by another program of public seminars. Complementing this program was a series of focus group discussions, each targeting a specific issue. The focus groups, comprising business representatives, academics specialising in taxation matters, taxation advisers and practitioners met with the Secretariat and, in some cases with Review Committee members, to discuss the options proposed in the discussion paper. The Review also called for submissions from the community on the issues canvassed in the paper. This consultative process involved 9 public seminars, 31 focus group meetings and the receipt of 300 submissions. The results of that process have been influential in improving the analysis of the issues and have been fully taken into account by the Review in reaching its judgments on particular issues.

Consultation is an essential feature of the ongoing tax system

17 In particular, the Review's experience with this consultative process has served to confirm its view that public consultation has an essential role to play in the development of a sound and workable business tax system. **The Review is strongly of the view that it is imperative that this process should be a continuing feature of the ongoing taxation system.** This will not only play a vital role in improving the efficiency and effectiveness of the system but is significant in building trust between the administrators and the users of the system. It also makes a major contribution to the understanding of the proposals being considered.

18 The Review is releasing with this report draft legislation and explanatory notes on some of the Review's recommendations. This legislation, and the policy it gives effect to, has been developed in accordance with the Review's recommendations regarding the processes for developing policy and legislation in an integrated manner which takes account of policy, legislative, compliance and administration issues.

19 The legislation and explanatory notes should be regarded as a snapshot of work in progress rather than a final product. They have been produced under considerable time pressure and consequently have been a stern test of the Review's proposed approach. They are being released as part of the report to illustrate the outcomes of the reformed processes and as a basis for further consultation.

20 The use of the recommended integrated taxation design process for the development of this legislation has convinced the Review that the proposed reforms are likely to lead to simpler and more effective tax legislation.

21 There are certain measures that the Review is recommending should be implemented ahead of the main body of the recommendations. In respect of these measures, the Review has forwarded to the Treasurer draft legislation intended to amend the current tax legislation. This legislation is necessarily more consistent with the current approach than that proposed by the Review. Once the full range of the Review's recommendations are reflected in new legislation the amendments dealing with interim measures will become redundant.

Objectives of the Review

Choosing national objectives as the focus of the tax system

22 In the Review's first issues paper, *A Strong Foundation,* the Review proposed three national objectives as a focus for the design of the business tax system. The consultative process revealed broad support for this general approach, although many submissions emphasised the need for certainty in regard to taxation outcomes. After considering the arguments put forward, the Review is recommending the adoption of the following objectives:

- optimising economic growth;
- promoting equity; and
- promoting simplicity and certainty.

23 These objectives underpin the recommendations the Review is making. There is no one-to-one matching between particular objectives and specific recommendations. The nature of tax policy development is that judgments have to be made and accepted about trade-offs between particular objectives. However, it is possible to identify some broad correspondence.

Optimising economic growth

Aligning the tax system more closely with commercial realities will boost economic growth and create jobs

24 The business tax system can significantly influence the efficiency with which Australia's natural resources, capital and labour are used. Ultimately the living standards of all Australians are determined by how well we allocate and use those resources. Consequently the business tax system is an important influence on Australia's future economic growth.

25 A starting point for the Review's recommendations has been that transactions with similar economic substance should be taxed in a similar manner. This should generally minimise the impact of the tax system on choices between alternative investments and so help to ensure that the allocation of resources reflects market realities.

26 In some cases practical concerns relating to administration and compliance costs have resulted in deviations from this general rule. A tax system which was theoretically pure but involved high compliance and administration costs would hamper rather than promote economic growth. Considerations relating to international competitiveness have also been important.

27 Increased international competitiveness is essential for the growth of the Australian economy and the creation of jobs for Australians. In today's environment Australian businesses can only survive by being internationally competitive. Measures aimed at increasing international competitiveness, therefore, do not have to focus only on cross-border transactions, or even on import competing or exporting industries. Any tax measure which results in lower costs for Australian business, or the development of new products or new markets, contributes to improving our international competitiveness.

Reducing the capital gains tax rate will encourage a greater level of investment, particularly in innovative, high growth companies

28 All Australians have an interest in the competitiveness of Australian industry. This determines the growth and vitality of the domestic economy which, in turn, determines the ability of governments to provide services such as health, education, welfare and security on a sustainable basis.

29 A major motivation for reform of the capital gains tax arrangements was the desire to increase the international competitiveness of Australian business and to encourage greater investment by Australians. The Review believes lower capital gains tax will improve the workings of Australian capital markets and encourage a greater level of investment and innovation. The constraint on lowering capital gains tax to maximise investment is that imposed by the need to maintain revenue neutrality. The measures recommended in this report are also designed to encourage greater investment in venture capital and so support new high growth businesses in Australia based on innovation and development of new markets.

30 Issues of international competitiveness are central to the consideration of the accelerated depreciation/company tax rate trade-off. Further, the impact on non-resident investors in Australian entities and on the ability of Australian companies to invest offshore was a major consideration in forming the recommendations on international taxation and the taxation of entity distributions.

Promoting equity

Equity requires a consistent approach to business taxation based on clear principles

31 Tax policy typically focuses on two concepts of equity: horizontal and vertical. Horizontal equity requires that taxpayers in similar situations are taxed in a similar manner and that transactions of similar economic substance are taxed similarly. Vertical equity requires that the tax system take account of society's views on the appropriate levels of taxation to be borne by taxpayers in different circumstances. An example of the tax system reflecting concerns about vertical equity is Australia's progressive personal income tax system which levies increasingly higher rates of tax as an individual's income increases.

32 While both concepts are relevant to designing a business tax system, horizontal equity is a more central concern. In Australia, vertical equity tends to be addressed primarily through the personal income tax and welfare systems.

33 Horizontal equity in the context of the business tax system is primarily about ensuring like treatment for like transactions. This has a number of dimensions. The formal application of the law must be equitable, but it is also important that limiting the scope for tax avoidance is squarely addressed. A tax system which tolerates significant levels of avoidance cannot be equitable and can be expected to fall into disrepute as the community witnesses the unfair outcomes.

Fairness requires a consistent and comprehensive approach to business taxation

34 The Review believes that the best way of addressing tax avoidance and promoting fairness is to put in place a consistent and comprehensive approach to business taxation based on a sound structure and foundation. A system based on clearly enunciated principles which treats all transactions on their merits is both the best way to ensure horizontal equity and to reduce tax avoidance and hence to improve the integrity of the system. However, the Review's recommendations also directly address the issue of tax avoidance and propose a number of reforms in this area.

35 Reforms of the taxation of financial arrangements, leasing and rights, income from entities, life insurance and the proposals for consolidation of company groups are all examples of measures aimed at providing a more consistent tax treatment and greater integrity for the tax system overall.

36 A major motivation of the reforms to the taxation of financial arrangements was to ensure that different financial instruments are taxed according to economic substance rather than legal form. The adoption of accruals taxation for certain financial arrangements will also reduce opportunities for unwarranted tax deferral.

37 Leases and rights are currently treated inconsistently. In some cases there is scope for avoidance by taxpayers, and in other areas the current treatment unduly penalises taxpayers. A more coherent and evenhanded treatment will underpin sound business practices and provide greater integrity to the tax system.

38 Problems with the inconsistent treatment of entities, particularly the different treatment of trusts and companies, have been well documented. The proposed treatment would simplify business arrangements while delivering more efficient outcomes and greater equity to taxpayers.

39 Without jeopardising the integrity of the system, the recommended tax treatment of income from investment earned through collective investment vehicles also improves equity and simplicity.

40 Current taxation arrangements for life insurers result in inconsistent treatment of similar investments undertaken with different life insurers — that is, life insurance companies compared with friendly societies — and of investments undertaken with life insurers compared with those undertaken by other entities. The arrangements also allow life insurers undue flexibility to allocate deductions to different forms of income at the expense of tax revenue. A more coherent treatment will ensure that investments with life insurers are treated in the same way as similar investments with other investment vehicles.

41 The Review's recommendations addressing the alienation of personal services income and the offsetting of losses from non-commercial activities will address a major inequity in the current taxation arrangements.

42 Generally the taxation of the full range of assets, liabilities and transactions should be based on consistent and clearly articulated principles. Correspondingly, where departures from that framework have been recommended, the reasons need to be spelt out. This helps ensure that the exceptions do not lead to unintended outcomes.

Promoting simplicity and certainty

A tax system based on clear principles also promotes simplicity and certainty

43 A major consideration in the formulation of the Review's recommendations has been to remove anomalies and inequities between the treatment of economically similar transactions. This will allow significant simplification of the tax system. Further, the redrafting of the tax legislation on the basis of a set of consistent principles will make the treatment of particular transactions clearer and less open to dispute. All these measures should contribute to reduced compliance costs and greater certainty in the operation of the tax system.

44 Recommendations to allow consolidation of company groups, while involving significant transitional costs, will markedly reduce compliance costs for groups of wholly owned companies while, at the same time, enhancing the integrity of the tax system.

45 The package of small business measures is expected to bring a substantial reduction in compliance costs for the small business sector.

Redrafting the tax legislation and putting in place a continuing simplification strategy will promote simplicity

46 A much clearer and shorter statement of the law, making a significant contribution to greater simplicity and certainty, flows from the redrafting of the tax legislation. However, the Review, has also recommended that an explicit simplification strategy be put in place. This strategy will have three elements:

- a volume reduction strategy aimed at significantly reducing the number of pages compared with the existing law;
- much more stringent control on net additions to the legislation through the integrated tax design process recommended by the Review to ensure that future additions to the law are made in the simplest and most concise manner possible; and
- a major emphasis placed on making tax legislation more accessible to taxpayers.

Effective community participation

A healthy and effective business tax system relies on continuing community participation in its development and administration

47 The Review regards effective community participation in the ongoing development of the business tax system as underpinning all three of the national objectives.

- A tax system which is well understood by business, and which takes due account of the commercial realities, will contribute to a much more supportive environment with business. It should encourage effort, innovation and measured risk-taking. Consequently, it can be expected to contribute to economic growth. It will also be easier to understand, and this simplicity will contribute to better compliance.
- Effective feedback from the community on the impact of the tax system is essential in evaluating its performance in terms of equity, simplicity and certainty. Further, the input of the community when the tax system is being designed or amended will help to reduce problems in those areas.

48 The Review is convinced that an effective tax system can only be maintained over time on the basis of cooperation between taxpayers and the tax administration. The foundation of such cooperation must be effective and ongoing consultation on all aspects of the tax system.

49 The Review's recommendations in respect of establishing a Board of Taxation and putting in place a Charter of Business Taxation are intended to ensure that consultation remains a high priority.

50 Commitment to continuing consultation on the business tax system will help to ensure that compliance costs for business are given appropriate weight in the consideration of both future changes and in the assessment of the ongoing effectiveness of the tax system.

The revenue constraint

Overall, tax reform will raise more revenue from business

51 As noted above, the Review's terms of reference require its recommendations to be revenue neutral in respect of the outcome from reforms to taxation of income from investment and from changes in the capital gains tax. It is important to note that revenue neutrality is to be measured against the increased contribution from business taxation predicted in *A New Tax System*. The total package of business tax measures — those proposed in *A New Tax System* and those recommended by the Review — is significantly revenue positive against the revenue generated by the current legislation and practices.

52 The Review has also accepted that losses to revenue from recommendations to vary the position set out in *A New Tax System* — such as the recommendation not to adopt the deferred company tax — must be considered in reaching the required revenue outcome. Table 1 shows the combined revenue impact of the entity measures announced in *A New Tax System* and the Review's recommendations.

Table 1 Revenue impact on business of all business tax reforms

	99-00 $m	00-01 $m	01-02 $m	02-03 $m	03-04 $m	04-05 $m
Revenue impact of entity tax proposals in *A New Tax System*	110	1,680	1,410	950	1,070	1,130
Revenue impact of Review's recommendations	-30	-270	120	30	540	-20
Total revenue impact of business tax reforms	**90**	**1,410**	**1,530**	**970**	**1,600**	**1,110**

53 The Review endorses fiscal policy settings based on ensuring that fiscal balance is achieved, on average, over the course of the economic cycle in order not to prejudice the budget surplus. In this context the

Review is supportive of the requirement that its recommendations should be subject to a revenue constraint.

A growth dividend

Tax reform is not a costless exercise. Those costs can only be justified if reform leads to higher growth

54 Motivating reform of the Australian business tax system must be the delivery of higher levels of economic growth. This is the overarching objective that has motivated our deliberations. Consequently, a major issue for the Review has been the identification of the growth dividend reflecting the increased Commonwealth tax revenue likely to flow from increased economic growth attributable to the recommended reforms. Such revenue needs to be included in the revenue neutrality assessment as it is clearly a benefit of the proposed reforms.

Behavioural responses are the desired outcome of tax reform but their size and effect on revenue are difficult to estimate

55 At the most fundamental level, this growth dividend is simply one aspect of the behavioural responses typically taken into account when developing revenue estimates for particular tax measures. For example, the estimation of the revenue impact of capital gains tax reforms includes an allowance for taxpayers switching investment from assets returning income in the form of dividends, interest or rents, to assets returning income in the form of capital gains, in order to access the benefit of the lower rates. This will occur only to the extent that the proposed reforms are more favourable than the existing benefits of indexation and averaging, which currently provide a similar incentive. On the same basis, it is important to incorporate the expected effects of taxpayers increasing savings and investment in response to the higher after-tax returns available as a result of the lower rates. In addition, as a more efficient and equitable tax system will capture current leakages from the system, revenues from the reduction in tax avoidance have to be included, as well as revenue arising from additional growth.

56 However, the effects of all behavioural responses are extremely difficult to estimate. As a result estimates are always likely to be conservative. For this reason the Review believes it is important that the assumptions made in this area be transparent. The behavioural assumptions underlying estimates for individual measures, where the effects are relatively specific to that measure, are set out in the revenue section in the body of the report.

57 The growth dividend reflects a broader efficiency gain that can reasonably be expected to flow from the combined package, over and above those gains and losses attributable to particular measures. The estimation of these effects is an order of difficulty greater than for those attributable to particular measures.

58 Table 2 shows estimates by the Review Secretariat of the revenue gain from a range of possible long-term increases in GDP attributable to business tax reform. For example, an increase in GDP of ¾ per cent means that in 2009-10 GDP would be ¾ per cent higher than it would be if tax reform was not undertaken and Commonwealth tax revenues would be $1.8 billion higher as a result. The increase in GDP would take some time to emerge and so the increase in GDP for 2004-05 would be markedly smaller and the increase in Commonwealth revenues commensurately smaller.

Table 2 Increased business tax revenue from increases in GDP

Increase in GDP by 2009-10 as a result of reforms %	Increased revenue in 2004-05 $m	Increased revenue in 2009-10 $m
0.25	220	600
0.50	450	1,200
0.75	650	1,800
1.00	850	2,400

It is extremely difficult to estimate the size of the likely growth dividend

59 The Review has not commissioned a study of the likely impact of the proposed business tax reforms on Australia's economic growth. Such studies typically involve models requiring a large number of assumptions that are difficult to validate. Overseas experience has demonstrated that alternative models can give markedly different results. Drawing comparisons from overseas studies is fraught with danger given the different starting points for their reforms and the fact that many of the studies relate to nations, such as the US, that have a low reliance on foreign investment. The impact of reforming taxation of investments in a capital importing country like Australia is likely to be larger, particularly when the reforms have international competitiveness as a focus.

There are a range of estimates available from studies that have attempted to estimate the benefits of other reforms

60 Modelling of the gain from the proposed GST/indirect tax switch in Australia has suggested long-term revenue gains of as much as 2 per cent arising from increased efficiency in the economy. It is difficult to draw a line from these reforms to the proposed business tax reforms in terms of a likely growth dividend. The GST involves a larger revenue switch but, as its main impact will be on consumption choices, its influence on investment decisions will be an indirect one. The business tax reforms will impact on investment choices directly.

61 There has been a number of other studies conducted in Australia on the benefits of micro-economic reform in one guise or another.

- The then Industry Commission estimated that the long-term boost to GDP from the competitive neutrality reforms (the Hilmer reforms)

would be 5.5 per cent after 10 years. The relatively limited reforms in the Commonwealth's area of responsibility were estimated to increase GDP by 1.0 per cent.

- The Industry Commission also estimated that the long run increase in GDP from Government contracting out and outsourcing could be as much as 1.7 per cent after 10 years.

62 Once again it is difficult to draw a line from these results to the likely impact of the proposed business tax reforms, although they do suggest that substantial gains are possible from reforms which result in a more efficient allocation of resources.

63 The Review acknowledges that economic models are sometimes useful in illustrating the possible impacts of reform packages such as that proposed by the Review. However, it is obvious that models fall well short of capturing all the complexities of the Australian economy and the international environment in which it operates. Consequently, the Review has accepted that the identification of an appropriate growth dividend has to be ultimately a matter of informed judgment.

There will be significant benefits from the Review's recommended reforms

64 The Review has been conscious that the proposed business tax reforms will involve industry in significant transitional costs. In addition, the revenue neutrality constraint means that in the absence of a substantial growth dividend, the gains to the winners would be offset by losses of an equal magnitude to the losers. There would be no point in undertaking reform if there is not to be a significant net national gain. It is therefore only logical to proceed with such a program if there is a belief that it would contribute to higher growth. The Review is firmly of the view that if its recommended reforms are implemented there will be significant national benefits.

A growth dividend of ¾ per cent of GDP by 2009-10 is likely to be conservative

65 In the light of the above, the Review believes a conservative judgment about the likely growth dividend would see a minimum increase in GDP of between ½ to ¾ of a per cent by 2009-10 and even ¾ of a per cent is likely to be conservative. The collective judgment of the Review is that the national dividend will be significantly greater than this but there is no reliable basis that can be drawn upon to unequivocally demonstrate this outcome.

66 Table 2 indicates that a growth dividend of ¾ of a per cent of GDP would deliver additional Commonwealth revenue of $650m by 2004-05. In order to ensure that the estimate of the overall revenue outcome of the Review's recommendations is clearly conservative only $500m of this expected revenue gain has been included in the revenue estimates for 2004-05. The estimates of the contribution to revenue from the growth dividend in earlier years have also been scaled back.

A compliance dividend

Business tax compliance costs were estimated at $9 billion in 1994-95

67 Business tax compliance costs under the current system were estimated at around $9 billion in 1994-95[3]. The costs would obviously be greater than this today reflecting both inflation and the growth in the number and size of businesses. However, no later estimates are available.

68 The $9 billion refers to the total cost imposed on the community. The actual costs to business are reduced by the tax deductibility of compliance costs incurred and the cash flow benefits which arise in some cases from the payment arrangements.

69 These estimates refer to both the compliance costs associated with the payment of taxes on business income and the compliance costs of collecting a range of other taxes including Fringe Benefits Tax, PAYE and other taxes on employee income. The total community cost of compliance associated with business income was estimated at $4.5 billion. After allowing for deductibility and cash flow benefits this fell to $2 billion.

The Review's recommendations should significantly reduce compliance costs

70 If the Review's recommendations reduce compliance costs in respect of business taxes by a conservatively estimated 10 per cent, the total community cost of compliance would fall by around $450 million in 1994-95 terms. This would mean that $450 million of the nation's resources which were previously engaged in essentially non-productive activity could be redirected to producing wealth for the nation. The initial impact would be to boost taxable income of businesses by $450 million and reduce the taxable income of those people or businesses providing compliance services by the same amount. There would appear to be little net initial impact on overall revenues.

71 However, the likelihood is that the $450 million would be devoted to productive activity which earned additional income. Savings of $450 million a year, if reflected in higher levels of investment, would see a larger capital stock over a period of years with consequent increases in taxable income and revenues.

Substantial compliance cost savings further support the case for a significant growth dividend

72 Given the inherent difficulties in identifying both the growth and compliance dividends, the Review is not going to claim a specific amount as a compliance dividend but the above arguments further support the case for including a growth dividend, recognising at the same time that the amount included is likely to seriously understate the potential.

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3 Evans C, Ritchie K, Tran-Nam B and Walpole M (1997), *A Report into Taxpayer Costs of Compliance*, Commonwealth of Australia, Canberra.

Revenue trade-offs

Revenue estimates are necessarily subject to a high degree of uncertainty

73 The estimated revenue impacts of virtually all the measures considered by the Review are subject to a significant degree of uncertainty. In many cases the available data have been inadequate to provide soundly based estimates and assumptions, some highly judgmental, had to be made in order to calculate the likely impact of a measure. In other cases measures are expected to result in significant behavioural responses and there is no objective basis on which to estimate the likely size of such responses.

74 The Review accepts that the estimates produced by the Secretariat, with substantial assistance from the Australian Taxation Office (ATO), are as good as can be produced. However, it is also conscious that the expected revenue impacts of measures introduced in the past have been significantly in error. For example, the actual contribution to revenue from the introduction of CGT and FBT substantially exceeded the Treasury estimates made at the time. The Review believes it has adopted a conservative approach to estimating revenue impacts and there is a likelihood that the package will be significantly more revenue positive than disclosed in the Review's estimates. If this proves to be the case, the Review believes that the extra revenue should be used to fund additional reforms to enhance further the competitiveness of the business tax system.

Reforms had to be judged on their relative merit given the revenue neutrality requirement

75 The Review identified a significant number of worthwhile reforms through its analysis of the current arrangements and as a result of the many submissions made to the Review, both through formal submissions and during the many consultative meetings that were held.

76 Unfortunately not all these reforms could be accommodated in the Review's recommendations. The revenue neutrality requirement imposed a tight discipline on the process and meant that the Review only decided on a final package as a result of judgments about the weight of argument for or against particular measures relative to other measures. The fact that a particular option has not been recommended by the Review does not always reflect a judgment about that option's absolute merit. In many cases it will reflect a judgment about its relative merits in terms of tax policy versus its revenue impact.

77 Noteworthy in this respect is the absence of a recommendation to allow a deduction for the amortisation of acquired goodwill. An argument is advanced that, given immediate deductibility of expenses helping to create goodwill and with the taxation of goodwill being only on a realisations basis, amortisation of goodwill cannot be justified on standard tax principles. However, Australian businesses in competition with overseas companies to acquire other businesses are at a competitive

disadvantage because some other jurisdictions, such as the US and UK, allow for the cost of acquired goodwill to be amortised in calculating taxable income.

78 The revenue cost of allowing amortisation of goodwill would be significant and could not be accommodated within the Review's revenue neutrality constraint. The Review believes it would be worthy of serious consideration, on competitive grounds, in the future if fiscal circumstances were appropriate.

79 The revenue neutrality constraint, of necessity, meant that the Review could only recommend reductions in tax burdens on business where the revenue cost could be met by increased tax burdens in other areas. The choice that the Review faced in each instance was whether 'spending' the revenue in a new way would provide greater benefits to business than if the revenue was 'spent' in the current manner, or as proposed in *A New Tax System*.

80 In some cases the current revenue loss is as a result of tax avoidance or anomalies in the law and it was relatively easy to reach a judgment that the revenue from correcting those situations could be used to fund other measures. Furthermore, these changes would provide overall benefits to business and the nation.

81 In other cases, such as the recommendation to use revenue from the abolition of capital gains tax averaging and indexation to fund effectively lower tax rates on capital gains for individuals and superannuation funds, the judgment was more evenly balanced.

The accelerated depreciation/ company tax rate reduction trade-off is the key issue

82 The most difficult judgment of all was in relation to the accelerated depreciation/company tax rate trade-off.

83 A reduction in the company tax rate will move Australia more into line with our competitors for international capital flows and will thus have a positive effect on the level of investment, economic growth and jobs. This will be offset to varying extents in those sectors of the economy benefiting from accelerated depreciation.

84 Accelerated depreciation is also seen as a positive by industry and an important factor for some industries in determining their international competitiveness. If accelerated depreciation were to be retained on these grounds there may be arguments for making the degree of acceleration across particular assets more uniform. A uniform degree of acceleration is seen as being less likely to adversely affect investment decisions. However, retaining any degree of acceleration would reduce the scope to reduce the company tax rate. Retaining accelerated depreciation would also impact on other elements of the Review's recommendations in areas such as leasing and rights.

Other countries typically allow some degree of accelerated depreciation, particularly for mining

85 The Review gave considerable weight to the international competitiveness issue. Clearly accelerated depreciation does provide considerable benefits to capital intensive industries. Further, the Review's information paper, *An International Perspective,* demonstrated that virtually all countries examined allowed some degree of acceleration, particularly in respect of mining.

A majority of submissions favoured a reduction in the company tax rate

86 On the other hand, there was a substantial majority of submissions favouring a reduction in the tax rate over continuation of accelerated depreciation. The decision as to which measure will deliver the strongest economic growth and vitality is crucial and will have a significant influence on the future shape of the Australian economy. It is essentially a judgment call. If the Government believes that reducing the company tax rate will deliver the best outcome, the elimination of accelerated depreciation will be necessary to achieve this. There are several points to note in relation to the Review's recommendations that are relevant to this decision.

- Entities that may lose through eliminating this concession will have offsetting gains through the lower tax rate and the recommended treatment of blackhole expenditures.
- Modelling of the overall tax reform package suggests that those industries most disadvantaged by the removal of accelerated depreciation will benefit by a more than offsetting amount from indirect tax reform.
- It should be noted that in an imputation system, such as Australia's, tax-preferred income arising from accelerated depreciation is clawed back upon distribution to shareholders.
- The simplified depreciation provisions for small business, which will cover 99 per cent of primary producers, will continue to provide accelerated depreciation for businesses which fall into this category.
- Elimination of accelerated depreciation will eliminate a major source of tax-preferred income. This permits greater simplification in many areas of the legislation without jeopardising the integrity of the system.

The choice between accelerated depreciation and reducing the company tax rate is not an easy one to make

87 However, the revenue neutrality constraint required that a judgment be made between these two options. This was not an easy judgment to make but the package of recommendations presented by the Review is predicated upon the abolition of accelerated depreciation and other revenue raising measures to finance a phased reduction in the company tax rate to 30 per cent.

88 It would be possible to modify the package by including an element of accelerated depreciation at the cost of increasing the company tax rate. This would also require, however, some additional modifications to the Review's proposals in order to protect the revenue against unintended tax-preferred income transfers. A significant part of the current complexity of the tax system arises from attempts to limit access to particular concessions. This is not necessary when tax-preferred income is not a major feature of the tax system. This combination of factors led to the Review opting for the lower tax rate alternative.

Implementation

89 The entity tax proposals in *A New Tax System* were intended to commence in the 2000-01 income year. Consequently the Review has taken this as its starting point in recommending the timing of implementation of particular recommendations. Table 3 sets out the Review's proposed timing of implementation for broad categories of measures. Further detail is available in the body of the report in respect of specific recommendations.

Table 3 Timing of implementation

Recommended measure	Implementation timing
Removal of accelerated depreciation	
businesses with turnover of $1,000,000 or more	Announcement
businesses with a turnover less than $1,000,000	1 July 2000 but applying to assets acquired after date of announcement
Removal of balancing charge rollovers	
businesses with turnover of $1,000,000 or more	Announcement
businesses with a turnover less than $1,000,000	1 July 2000
Preventing assignment of leases	22 February 1999
Write-off for rights	
Indefeasible rights to use	Announcement
Other	1 July 2000
Repeal of excess mining deductions rules	Announcement
Other investment measures	1 July 2000
Entity measures	1 July 2000
Small business	1 July 2000

Table 3 Timing of implementation (contd)

Recommended measure	Implementation timing
Capital gains tax	
Removal of averaging	Announcement
Freezing of indexation	30 September 1999
Percentage of gains included in taxable income	1 October 1999
Scrip-for- scrip	Announcement
Venture capital	Announcement
Integrity measures	
Loss duplication	22 February 1999, date of announcement, 1 July 2000
Value shifting	22 February 1999, 1 July 2000
Other	1 July 2000
Fringe benefits taxation	
Repeal FBT on entertainment	2002-03
Other measures	2001-02
High level rules	1 July 2000

The Review's recommendations are revenue neutral

90 Table 4 sets out the overall revenue implications of the Review's recommendations. The cost of the company tax rate reduction has two main elements. The first is the reduced revenue gains from the Government's business tax measures announced in *A New Tax System* as a result of the company tax rate being reduced from 36 per cent to 34 per cent in 2000-01 and 30 per cent thereafter. The revenue loss in respect of these measures is significant.

91 The second, and major, component is the cost of reducing the company tax rate in respect of the existing company tax base.

92 The changes to the taxation of investments and income from entities are costed on the basis of the proposed company tax rates. The major offsetting element is the revenue gain from the removal of accelerated depreciation.

Table 4 **Revenue implications of Review's recommendations**

	99-00 $m	00-01 $m	01-02 $m	02-03 $m	03-04 $m	04-05 $m
Company tax rate (%)	**36**	**34**	**30**	**30**	**30**	**30**
Loss of revenue from *A New Tax System* measures as a result of reducing company tax rate[(a)]	-10	-190	-680	-320	-370	-380
Cost to revenue of reducing company tax rate on existing base		-1,160	-2,840	-2,740	-2,740	-3,030
Total cost of company tax rate reduction	**-10**	**-1,350**	**-3,520**	**-3,060**	**-3,100**	**-3,410**
Removal of accelerated depreciation	40	1,150	2,220	2,300	2,610	2,550
Other changes to taxation of investments	10	390	770	120	-100	-300
Total revenue from changes to taxation of investments	**50**	**1,540**	**2,990**	**2,420**	**2,520**	**2,260**
Changes to taxation of income from entities	**-60**	**-660**	**-360**	**-410**	**-240**	**-290**
Small business measures		**-520**	**-530**	**-210**	**-330**	**-420**
Integrity measures		**530**	**1,030**	**980**	**980**	**990**
CGT reforms		**160**	**170**	**100**	**50**	**-30**
FBT reforms			**10**	**-210**	**70**	**100**
High level design reforms		**-30**	**220**	**210**	**290**	**280**
Growth dividend		**50**	**100**	**200**	**300**	**500**
Revenue impact of package	**-30**	**-270**	**120**	**30**	**540**	**-20**

(a) The estimate incorporates the impact of base broadening on revenue gained from trusts at the recommended company tax rates; that is, the measure is costed against the Review's recommendations.

93 Detailed tables showing the revenue impact of each measure are included in Section 24.

Impact of the Review's recommendations

Reforms are not a zero sum game despite revenue neutrality

94 The revenue neutrality constraint might, at first glance, be thought to imply that the Review's recommendations represent a zero sum game. In fact, to the extent that the Review's reforms increase economic growth and reduce compliance costs there will be clear net gains to business, Government and the community generally. The growth dividend reflects only the part of those gains paid in tax. The remainder is a net benefit to business as a whole.

95 In addition, the Review expects its recommendations to stem many of the tax leakages which currently undermine the system. The sounder structure of the legislation and the more consistent approach to issues will minimise the opportunities for avoidance. As noted, the Review believes that the revenue benefits from such an outcome, many of which are not captured in the current estimates, should be directed at further improving the international competitiveness of Australian business.

Accelerated depreciation/company tax rate trade-off

There will be both winners and losers from the trade-off, but more winners than losers

96 The major trade-off relates to the abolition of accelerated depreciation and the reduction of the company tax rate to 30 per cent. The immediate impacts of these two measures are relatively easy to identify.

97 All entities with taxable income will benefit from the reduction of the company tax rate. It will not directly benefit taxpayers facing personal tax rates and it will not immediately benefit entities in tax loss. But in evaluating the effects of tax reform regard has to be had to the total tax package, including changes to indirect taxation and the personal tax scales.

98 The reduction in the company tax rate will of course, increase the after-tax profits of Australian companies. If the lower company tax were to be fully reflected in greater dividend payments, both domestic and non-resident shareholders would receive a cash flow benefit. If the dividend payment were to be unchanged in absolute terms, the amount of income retained by the company would be greater with benefits in terms of increased investment.

Removal of accelerated depreciation will impact adversely on some investments

99 Removing accelerated depreciation will impact adversely on those businesses, other than small businesses, currently taking advantage of accelerated depreciation in respect of their plant and equipment. It will also impact adversely on major resource projects which tend to be financed to a significant extent through non-recourse debt. The cash flow benefits of accelerated depreciation significantly reduce the risk of funding such projects and consequently improve funding availability.

100 As noted in *A Platform for Consultation* (Table B.2, page 106) the rate of acceleration varies markedly across the range of plant and equipment. Consequently, the impact on particular businesses will depend not only on their capital intensity but on the rate of acceleration applying to the particular assets they use.

101 The net impact of the company tax rate reduction/accelerated depreciation trade-off on individual companies will depend on the extent to which they currently benefit from accelerated depreciation. The volume of capital intensive investments is likely to be lower than would otherwise be the case, reflecting the net disadvantage to such investments from the accelerated depreciation/company tax rate trade-off. Conversely, the volume of less capital intensive investments is likely to be higher than would otherwise have been the case.

102 To the extent that companies receiving a net benefit from the trade-off on individual companies then increase distributions of franked income, the benefit of any reduction in the company tax rate would be clawed back by the imputation system for resident shareholders. For non-resident shareholders the total amount of tax paid will have fallen from 36 per cent to 30 per cent and so they will receive a significant reduction in Australian tax. For unfranked dividends the position of both resident and non-resident shareholders will be unchanged. However, it is important to note that the accelerated depreciation/company tax rate trade-off will reduce the proportion of tax-preferred income, and consequently increase the proportion of franked dividends, paid by Australian companies.

103 Alternatively, companies may reflect any net benefits of the switch in a higher level of retained earnings. This will lead to greater levels of investment and increased future profits to the benefit of shareholders.

The relative impact of proposed reforms on particular industries has been modelled

104 The above analysis focuses principally on the first round effects of the change. There will be a range of second round effects as some activities expand and others contract. The Department of Industry, Science and Resources has commissioned a study which provides some estimates of the impact of the business tax reforms on individual industries.

105 The study used the Econtech MM303 model to simulate the effect of the direct impact on industry costs of those changes in business taxation which could be allocated to industry. The model captures the indirect effects arising from changes in industry costs and the prices of their outputs. The study necessarily relies on a number of assumptions which may or may not be borne out in practice. The details of the study and the results are discussed in Section 25.

106 No attempt has been made to estimate the size of any growth dividend flowing from the Review's recommendations for the reasons set out earlier. The focus was on estimating the relative impact of the Review's recommendations on industry output.

All industries are likely to be better off

107 What the results indicate is that a marked disparity between the impacts on particular industries is unlikely. Some will grow marginally more slowly than might otherwise have been the case, while others will grow slightly more quickly. If the overall package results in a growth dividend of the order anticipated by the Review — an increase of ¾ per cent in GDP over the longer term — then all industries are likely to be better off as a result of the Review's recommendations.

Compliance costs

Reduced compliance costs will be a major benefit to Australian business

108 The Review's recommendations are intended to provide a more consistent and easily understood business tax system.

109 The comprehensive examination of the full range of business tax measures has meant that anomalies and inconsistencies have been identified and removed. For example, the recommendations will replace 37 different capital allowance regimes with two simpler regimes. Transactions which are similar in terms of economic substance will be taxed in similar ways.

110 Adoption of the Review's recommendations will move tax treatment and accounting treatment closer together in many areas.

111 The tax legislation will be restructured on the basis of high level and consistent principles. Where a case has been made for deviations from these principles the deviation will be made explicitly and the reasons explained.

112 All of these changes should contribute to markedly lower compliance costs for business and simpler administration for the tax authorities.

113 The Review's proposals for a Board of Taxation, a Charter of Business Taxation and a much more extensive ongoing consultation process will all work to ensure that reducing compliance costs will remain a high priority in the future development of the business tax system.

There has been a particular focus on reducing compliance costs for small business

114 The focus of the small business initiative recommended by the Review is on simplifying the interaction of small businesses with the tax system. The simplified tax system for small business will be available to over 95 per cent of businesses in Australia. As noted earlier, it has been claimed that almost 40 per cent of the estimated $9 billion compliance

costs incurred by Australian business is incurred by small business[4]. The Review's recommendations will lead to a substantial reduction in these costs.

Impact on businesses

Recommended reforms will support the globalisation of Australian business and reduce compliance costs

115 Where once Australia's international businesses were largely concentrated in the resource industries they are now found in almost every type of business. Australian firms are increasingly important players in a growing range of international markets.

116 The Review has been very conscious of the need to ensure that the tax system facilitates the internationalisation of Australian business. The Review is recommending that imputation credits be allowed for foreign dividend withholding taxes paid on foreign source income of Australian entities, up to 15 per cent. This will remove a disincentive for Australian firms to expand overseas.

117 The Review is also recommending against the deferred company tax proposal, partly on the grounds of the adverse impact on non-portfolio foreign investors. Another important consideration was that the deferred company tax would have had a negative impact on reported company profits without advantaging shareholders, and with only a short-term timing effect on Government revenues. The treatment of so-called conduit income — foreign source income flowing through Australian entities to non-residents — will also be improved.

118 Consolidation will be a major benefit to large Australian business groups. It will allow transactions between wholly owned companies to take place without any tax consequences. This will result in large savings in tax compliance costs and allow decisions about such transactions to be made entirely on commercial grounds. In particular, it will allow company groups to restructure without incurring significant taxation consequences. The recommendations in this area are believed to be practicable, overcoming the major transitional difficulties, and adding significantly to the integrity of the system.

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4 Evans C, Ritchie K, Tran-Nam B and Walpole M (1977), *A Report into Taxpayer Costs of Compliance*, Commonwealth of Australia, Canberra, table 4.10, page 51. (Note: for the purpose of this study small business has a turnover of less than $100,000.)

Impact on small business

The small businesses of today are the large businesses of tomorrow

119 As pointed out earlier the simplified tax system for small business will have a major favourable impact on the compliance costs faced by 95 per cent of Australia's businesses.

120 Included in the simplified tax system are simplified depreciation arrangements having the effect of shielding most small businesses from removal of accelerated depreciation as a general measure. This is particularly important in the case of unincorporated primary producers and other businesses which will not benefit from the reduction in the company tax rate, although they will benefit from the personal income tax scale reductions which are part of the total tax reform package.

121 The proposals in respect of venture capital are aimed at encouraging investment in small, innovative businesses. This is an area which could be a major contributor to higher economic growth and employment. Experience in other countries, most notably the US but also in the UK, has been that creating the right investment climate can lead to major growth of innovative small businesses. These small businesses are the large businesses of tomorrow. An economic climate that is conducive to the spawning of new businesses is more likely to generate an economy of greater vitality and creativity which is the mechanism for delivering higher living standards to the Australian community.

122 Restructuring of the small business capital gains rollover and exemption arrangements, as recommended, will also provide a simpler and more accessible concession for owners of small businesses, while still retaining the original intention of facilitating small business growth and reinvestment and helping to fund retirement.

Impact on investors

Reforms to CGT, refunds of imputation credits and the establishment of flow through taxation of collective investment vehicles will provide greater incentives for individuals to invest

123 The proposed capital gains tax arrangements for individuals will eliminate some unintended outcomes from the way in which the averaging provisions have been used. The revenue savings can be used in a more productive way to encourage investment. This should improve the operation of Australian capital markets to the benefit of both large and small businesses.

124 Refundable imputation credits will provide a major improvement in the equity of the imputation system and provide improved returns on share investments for low income taxpayers who currently are unable to make full use of their franking credits. It will also remove a disincentive for investment in shares by superannuation funds.

125 The establishment of collective investment vehicles (CIVs) outside the entity regime will ensure that small individual investors have the same opportunities to invest in a range of projects as those who have the capacity to invest directly. In this context the Review's recommendation that tax-preferred income earned through a CIV should be tax exempt in the hands of the individual investors is very important. This will ensure that individual small investors can invest in a project through a CIV on equivalent terms with wealthier individuals investing directly.

126 As noted earlier the position of non-resident investors will also be improved by a number of the Review's recommendations.

Summary

127 The Review is confident that its recommendations address the objectives identified earlier. A reformed business tax system based on those recommendations will support a more efficient, innovative and internationally competitive Australian business sector. This will be of enduring benefit to all Australians, in terms of higher employment, improved returns on savings and ensuring a sustainable revenue base to fund the essential services provided by Government.

128 An overview of the Review's recommendations is provided below and details of each recommendation and the rationale for them are provided in the body of the report.

Building a strong foundation

Policy formulation

An architecture for reform

An integrated tax design process to bring together policy, legislative, administrative and compliance issues

129 An integrated tax design process is being proposed in order to ensure that policy, legislative and administrative/compliance concerns are all given appropriate weight and addressed in a comprehensive manner in the development of new tax proposals. As noted in *A Strong Foundation,* the experience in the past has been for policy development, legislative design and administration to be done sequentially with inadequate feedback between the three stages. This has often produced unsatisfactory outcomes from one, or indeed all, of the perspectives involved. The integrated approach has been adopted by the Review during the development of the issues papers, draft legislation and this

report. This has demonstrated to those involved the practical benefits of adopting this approach and why the Review so strongly recommends it.

A Charter of Business Taxation

Setting out the objectives and principles for business taxation in a *Charter of Business Taxation*

130 The Review is recommending that a *Charter of Business Taxation* be adopted. The Review is also recommending the adoption of an enduring new framework for business taxation in Australia, based on national objectives and framework design principles. The setting out of these objectives and principles in a *Charter of Business Taxation* will give them lasting visibility, focus and status, and assist in making accountable those responsible for their implementation.

131 The Charter has as its core three national objectives:

- optimising economic growth;
- promoting equity; and
- promoting simplicity and certainty.

132 Rather than being based on legislative authority, the Charter will rely on the continued support of all parties, both private and public sector, for its continuing effectiveness.

A Board of Taxation

A Board of Taxation will monitor the maintenance and development of the tax system

133 The Board of Taxation will be responsible for monitoring adherence to the Charter and for ensuring that it remains relevant to a changing business environment. Members of the Board will be drawn from the Australian business community. The Board will also include senior representatives from the Treasury, the ATO and one other Government agency. The private sector representatives will constitute a majority of the members and will be appointed on the basis of their personal capacities rather than representing particular interests.

134 The Board will advise on consultative processes to be followed in developing taxation policy and the related legislation and administrative practices.

135 The Board will also review and report on the performance of the business taxation system against the objectives and principles set out in the Charter. In addition, the Board will also participate in the development of a forward work program for the business tax system.

Forward work program

A forward work program will be part of a more open and inclusive process for the business tax system

136 There is a need for a more open and inclusive process for developing the business tax system and the Review is proposing the adoption of a forward work program as an important element of that process.

137 Treasury and the ATO will develop an annual forward work program for consideration by the Treasurer. The Board will be asked to comment on this program and then to monitor (not manage) its implementation. The forward work program will ensure a high level of awareness about policy issues under consideration by the Government. In cases where an issue was particularly sensitive there may be a need to keep confidential the fact that policy changes are being considered. However, it will be the intention that such cases should be very much the exception to the rule. In these cases the opportunity for direct input from members of the Board will still help to broaden the perspective in which the matters are being considered.

Legislation

Simplification strategy

An explicit focus on simplification is necessary

138 The Review is also recommending the adoption of an ongoing simplification strategy. The redrafting of the tax legislation which has been commenced by the Review, and which will continue as part of the implementation of the business tax reforms, provides a major simplification of the existing system. However, in the absence of specific processes to prevent it, there is a likelihood of many of these benefits being eroded over time as changes are made to the tax law in response to particular policy issues. The integrated tax design process proposed by the Review will help to reduce this risk. However, an explicit focus on simplification, both in assessing proposed changes and in reviewing the existing law, will provide a further protection against the creeping complexity which has been a feature of the last 30 years of tax legislative development. It will be a prime responsibility of the Board to be vigilant in drawing attention to any such tendencies.

Administration

139 The Review has brought into focus a number of significant problems with the administrative regime which governs the way business taxpayers interact with the system. In large part these problems derive from the piecemeal approach which has evolved, with each process being largely a discrete exercise. The regime for dispute resolution, in

particular, predates the introduction of self-assessment and is needlessly tortuous, often unacceptably slow and costly, and overly adversarial. The Review has therefore recommended that the administrative processes be redesigned with a view to overcoming these deficiencies and reducing times and costs, particularly in relation to small claims.

A more comprehensive rulings system

Increasing the scope of the rulings system to provide greater reliability, timeliness, and certainty

140 The Review is recommending an expansion to the scope of the public and private rulings system consistent with the proposals made in *A New Tax System*. This will allow the Commissioner to issue rulings on procedural, administrative or collection matters and on ultimate conclusions of fact. In addition, the Review recommends that the Commissioner be specifically allowed to rule on the potential application of the general anti-avoidance provisions. These recommendations will remedy current limitations in the scope of the public and private rulings system, and provide greater flexibility and certainty to taxpayers.

A durable framework for income taxation

Cashflow/tax value approach

A more consistent framework will deliver greater integrity, simplicity and certainty

141 Fundamental to the reforms of the business tax system recommended by the Review is a principle-based framework for a reformed income taxation system.

142 The recommended framework is driven by the need to improve the structural integrity of the system, to reduce complexity and uncertainty, to provide a basis for ongoing simplification and to align more closely taxation law with accounting principles.

143 The existing law is based on legal concepts of income that have built up over time. Centrally, it involves the concepts of ordinary income, statutory income including capital gains and expenses, and losses of either a revenue or capital nature.

144 As a consequence of the evolution of the existing law, assets may be taxed in a variety of ways depending on the purpose for which they are held. This creates uncertainty and complexity in the law.

145 To distinguish expenses consumed in a tax year from expenses that essentially involve a conversion from one type of asset to another asset, the existing tax system uses the concept of capital expenditure. The

absence of statutory principles has resulted in uncertainty and led to the mischaracterisation of some expenses.

146 The Review is strongly of the view that a more coherent and durable legislative basis for determining taxable income is essential to reduce uncertainty and complexity in the present system. A redesigned tax system will underpin a more consistent, transparent and sustainable tax system. Having a structure which is more enduring and robust, and which can flexibly accommodate future changes within the structure, has much to commend it.

Features of the cashflow/tax value approach

A consistent treatment of expenditure and assets is central to the new framework

147 Determination of taxable income under the cashflow/tax value approach involves recognition of the two components of a taxpayer's income — the net annual cash flows from use of relevant assets and liabilities and the change in tax value of those assets and liabilities (see *A Platform for Consultation*, pages 27-34). Recognising the practical constraints in taxing the annual change in value of all assets, the use of tax values ensures that taxpayers will generally continue not be taxed on unrealised increases in asset values.

148 Defining income in a manner structurally consistent with both economic and accounting approaches to income measurement — rather than relying on the current mix of statutory and judicial definitions of assessable income offset by an unstructured set of deductions — supplies the high level unifying principle that cannot be found anywhere in the current income tax legislation. Application of that unifying principle will provide a structural integrity and durability to the income tax law that the existing patchwork definitions simply cannot offer, however they might be amended.

149 An essential element of income measurement is the deduction of expenses consumed in the course of deriving gains. A treatment of expenditure which is consistent with the accounting approach of classifying expenditure according to whether it gives rise to an asset on hand at year-end is a fundamental feature of the cashflow/tax value approach. All non-private expenditure, including existing blackhole expenses will be recognised in the calculation of taxable income —unless specifically excluded by the law for policy reasons.

150 Where the expenditure gives rise to an asset and that asset is recognised for tax purposes at the end of a year, its tax value will be brought to account at that time unless specifically exempted. This is similar to the treatment of trading stock in the existing law. Under this

approach, expenditure will be deductible over the period in which identifiable benefits are received from the expenditure.

151 Concerns have been raised in consultations that the new approach may expand the tax base by stealth as a result of starting from a point of general principle and identifying exceptions by specific 'carve-outs'. The Review has identified some expenditures, such as advertising, where a literal application of the approach might expand the tax base in such a way, and therefore has retained their treatment under the current system. In addition, the Review is recommending that, if experience discloses an unintended expansion of the business tax base, this be rectified — either directly or by adjustment to tax rates.

Tax value of assets and liabilities

Critical features of the new approach are the tax value rules for assets and liabilities and the meaning of asset and liability

152 The cashflow/tax value approach provides for the change in the tax value of assets and liabilities on hand at year-end to be taken into account in the calculation of taxable income. Increases in the tax value of assets and reductions in the tax value of liabilities will add to taxable income while tax value decreases in assets and increases in liabilities will reduce taxable income.

153 The meaning of 'asset' will draw on the accounting definition of an asset. Similarly, the meaning of 'liability' will draw on the accounting definition. Some accounting liabilities, such as provisions for future employee entitlements, will have a zero tax value. Asset and liability are defined in the draft legislation accompanying this report.

154 Some transitional costs will be imposed on taxpayers and their advisors as well as the Australian Taxation Office as a result of the introduction of new concepts and newly defined terms such as asset and liability. The Review considers that these transitional costs can be justified because of the greater simplification, certainty, transparency and durability of the recommended framework. The new approach to structure will produce long term benefits for Australia's tax system which the Review believes will far outweigh the shorter term costs.

155 The adoption of tax values of assets and liabilities will have little practical impact on most small business taxpayers because of the Review's recommendations allowing them to opt into a simplified tax system that includes cash accounting.

Calculation of taxable income

Taxable income based on cash flows and changing tax values of assets and liabilities

156 In *A Platform For Consultation* (pages 39-44) the Review discussed two options for determining taxable income under the framework

has greater structural integrity

incorporating changing tax values of assets and liabilities. The choice was between maintaining the existing assessable income and allowable deductions dichotomy or adopting an approach based on cash flows and changing tax values of assets and liabilities. Both options are intended to, and would produce the same outcome as derived by current methods of calculation. The second option provides greater structural integrity and is recommended, for that reason.

157 The Review's recommendation is that the approach to be taken in framing the legislation for the calculation of taxable income should be based on cash flows and changing tax values of assets and liabilities. The recommended approach is not a revolutionary way of calculating taxable income that departs from all established processes. It does not result in radically different outcomes, such as bringing to tax unrealised gains. Substantively the same calculations need to be made under the existing law and the proposed approach. It should be noted that the new approach will not require any changes to existing computer systems apart from those flowing directly from policy reform measures. The results from current methods can be reconciled as shown in the example comparing the calculation of taxable income under the new approach with that under the current system in Attachment A, Section 4 of the report.

158 The recommended approach is consistent with accounting principles and provides a more durable structure for future taxation changes and a more logical framework in which to set out the basis for the calculation of taxable income. Greater integrity will flow from the consistent treatment of assets and liabilities promoted by the new cashflow/tax value approach.

General deductibility of interest

Non-private interest expenses will be immediately deductible

159 An implication of the new approach is that interest expenses of a non-private nature will generally be immediately deductible. Under present arrangements they are deductible in some cases, capitalised in others or not deductible at all. The boundary line between the different outcomes is not particularly clear — leading to uncertainty and increased compliance costs.

160 The payment of interest simply ensures continued access to a level of funding rather than itself creating an asset. Therefore it is appropriate that, as a general rule, it be immediately deductible .

Recognition of blackhole expenditures

A major benefit for business will be the consistent recognition

161 The cashflow/tax value approach will also address the issue of blackhole expenditures. Under current law a number of business expenses are not recognised for tax purposes. Under the proposed

of so-called blackhole expenditures

approach all non-private expenditures will be included in the calculation of taxable income.

- Where the expenditure improves a depreciable asset or is a depreciating asset in its own right, it will be deductible over time under the treatment for depreciable assets. For example, the cost of a successful feasibility study will be written off over the life of the resultant investment.
- Where the benefit of the expenditure extends over an indeterminate period but is likely to decline, a statutory write-off is proposed — over five years for incorporation expenses for companies.
- Where the expenditure creates or improves a non-depreciable asset it will be included in the cost base of the asset. An example would be landscaping expenditure in relation to real estate.
- Where the expenditure does not form part of the cost of an identifiable asset nor reduces a liability, it will be immediately deductible — for example, business relocation costs or export market development expenditures.

Consistent treatment of prepayments

Prepayments will be taxed in the years to which the payments relate

162 Under the existing law an immediate deduction is allowed for advance expenditure incurred (prepayments) for the provision of services for a period up to 13 months. This 13 month rule allows an inappropriate bringing forward of deductions and also provides inconsistent treatment between payers and payees. As a general rule, a prepayment received by a taxpayer is not included as income until the services to which the payment relates have been provided.

163 The Review is recommending that prepayments be allocated over the income years to which the payments relate both for taxpayers incurring the expenditure and also taxpayers receiving the payment. There will be an exception to this rule for individuals and small business taxpayers using a cash basis of calculating taxable income. Most prepayments covering a period up to 12 months will be taken into account at the time of payment/receipt for cash basis taxpayers.

164 The proposed treatment of prepayments will improve the structural integrity of the tax system.

Definition and valuation of trading stock

A definition of trading stock is required to differentiate these assets from the more general class of investment assets

165 A concept of trading stock has been retained in order to recognise the specific characteristics of this category of assets. The valuation of trading stock will be the lower of cost or net realisable value, which is the accounting method of valuing inventories. Taxpayers will have the

option to make a generally irrevocable election to use market selling value for trading stock. Trading stock will be limited to tangible assets and therefore will not include financial assets.

Assets receiving capital gains treatment

Certain assets will receive capital gains and loss-quarantining treatment

166 The Review has identified particular assets that will be subject to capital gains treatment. Individuals will only have to include 50 per cent of the nominal gain realised on any asset, while complying superannuation funds will include two-thirds of any nominal gain realised. Losses on these assets will be quarantined against capital gains for all taxpayers.

167 More detail on the proposed treatment of capital gains is provided later in this Overview and in the body of the report.

A no-detriment approach to involuntary receipts

168 The current taxation rules for involuntary receipts do not result in consistent treatment. The Review is recommending reforms that will ensure a consistent treatment of involuntary disposals in a range of circumstances. The aim of the reforms is to ensure that taxpayers are neither advantaged nor disadvantaged by the tax system in such cases.

A new approach to taxing fringe benefits

Transfer of liability to employee

Taxing fringe benefits in the hands of employees will significantly improve the equity of the tax

169 Taxing fringe benefits by imposing a liability on the employer is inequitable in a number of respects. Firstly, it imposes a tax liability on employers in respect of the income of the employee. Secondly, the tax liability is calculated at the top personal marginal tax rate irrespective of the marginal tax rate faced by the particular employee.

170 The Review believes there will be substantial benefits from transferring the tax liability for fringe benefits to the employee receiving those benefits and, with the other recommendations being made, the fringe benefits legislation could be repealed without any loss to revenue and with the elimination of a separate tax administration. Consultations have seen widespread, although not unanimous, support for the Review's position.

171 Consequently the Review is recommending that all employee fringe benefits be assigned to the individual employee and taxed under the PAYE system. This will ensure that income received as fringe

benefits by an employee was taxed at the same personal marginal tax rate as any other form of employee remuneration.

The change will not significantly increase compliance costs relative to proposals in *A New Tax System*

172 There have been suggestions that such a switch would massively increase the number of taxpayers in respect of fringe benefits and so lead to significantly increased compliance costs. This reflects a confusion of who is liable for a tax with how the tax is to be collected. In fact the tax collection task will remain with the employer, as with the taxation of other elements of remuneration, and there will only be a minor change in the way the tax is to be calculated and remitted. The collection points will be identical with those under current FBT legislation — the employers of those receiving the benefits. The fringe benefits assigned to an employee will simply be included in his or her income, in the same way in which bonuses are treated, and be subject to the current PAYE arrangements.

173 The fringe benefit changes announced in *A New Tax System* require that if total fringe benefits exceed $1,000 per annum, employers assign the benefits to individual employees on their group certificates. The Review is recommending no *de minimis* level except that, as now, the existing exemptions for irregular minor benefits under the current FBT provisions will be retained and the compliance costs associated with very low levels of fringe benefits will continue to be avoided. Consequently, the Review's proposals involve only a small additional administrative step added to the proposals in *A New Tax System*.

Some employment contracts may require renegotiation

174 The Review is conscious that taxing fringe benefits in employees' hands might require some renegotiation of employment contracts. For many employees on salary packages costed to include the full cost to the employer of any fringe benefits, including the tax itself, there will be no significant effect. The only exception will be the benefit for those employees who will be taxed on the fringe benefits at their own marginal tax rate where this is lower than the top marginal tax rate at which FBT is currently levied. The tax saving to the employer of transferring the fringe benefits tax liability to the employee will need to be reflected in a higher salary to the employee and the details of this may need to be negotiated. Such compensating increases to leave employees in the same position will not represent a higher cost to employers.

175 The result will be a more sound and equitable system. Now is also the time to make such a change in the context of a fundamental reform of the Australian tax system.

176 *A New Tax System* announced that the new FBT arrangements will apply from the 1999-2000 and 2000-01 FBT years of income, and putting in place arrangements to meet those requirements will impose a significant burden on employers. Consequently the Review is proposing that the transfer of tax liability for fringe benefits to the employee only apply from and including the income year 2001-02.

Exclusion of entertainment and on-premises car parking

The application of FBT to entertainment and on-premises car parking has always been contentious and administratively difficult

177 *A New Tax System* proposed that both entertainment and on-premises car parking be excluded from the requirement to report fringe benefits on employees' group certificates. This reflected a judgment that the allocation of these benefits to individual employees would involve unacceptably high compliance costs. In addition, the fringe benefit tax treatment of these items has always been contentious and complex.

178 The Review is recommending that business-related entertainment expenses no longer be treated as fringe benefits and simply be made non-deductible from and including income year 2002-03. The later start time is driven by the transitional revenue cost in the first year and the need for the Review's recommendations to be as revenue neutral as possible in each year.

179 The Review notes that removing entertainment from fringe benefits coverage will also mean that it was not taxable when provided by a tax-exempt employer and the offset of making it non-deductible is not relevant in such cases. The administrative difficulty of trying to address this issue is probably not justified given that such expenditure by tax-exempt employers is relatively minor.

180 The Review is also recommending that on-premises car parking be removed from FBT coverage. The Government has moved to exempt small business from fringe benefits on on-premises car parking and non-CBD parking is largely exempted because of a *de minimis* value rule. So exempting all 'on-premises' car parking will make the treatment of this expense consistent across all forms of business as well as reducing compliance costs and removing a source of considerable annoyance and angst.

Reform of motor vehicle fringe benefits

Taxing of motor vehicle fringe benefits is to be reformed and made less concessional in order to finance other FBT changes

181 Without further adjustment to the fringe benefits regime, the net effect of these fringe benefits reforms would be revenue negative. However, the present treatment of car fringe benefits is unsatisfactory in a number of respects and strongly concessional. Reducing (while not eliminating) the concessionality of car fringe benefits will make the package of fringe benefit reforms revenue neutral in the short to medium term and allow some rationalisation of these arrangements.

182 Accordingly, the Review is recommending that the current statutory formula for valuing car fringe benefits be replaced with a schedular approach under which 55 per cent private use is assumed in determining the taxable value of a car benefit. Taxpayers will have the option of opting out of the formula and substantiating the actual degree of private use if they so wished. In either case, the treatment of car fringe benefits will still be concessional for most employees and so cars will remain a popular form of fringe benefit.

Treatment of exempt and rebatable employers

FBT concessions are not an efficient or appropriate way to assist charities and other tax-exempt bodies

183 As raised in *A Platform for Consultation*, dispensing with FBT and transferring tax liability to relevant employees will in itself eliminate the advantage enjoyed by exempt and rebatable employers from paying employees in the form of fringe benefits. Therefore a different approach will be required for these organisations if they are to be compensated for the loss of the advantage.

184 *A New Tax System* proposed to limit the amount of fringe benefits per employee which could qualify for concessional treatment to a grossed-up value of $17,000 per year. This suggests that one approach under the Review's proposals could be to allow each employee of a tax-exempt organisation an income tax deduction of $8,000 per year and a proportionate deduction for employees of a rebatable employer. (An $8,000 deduction will be of the same benefit as exempting from FBT fringe benefits with a grossed-up value of $17,000.)

185 The Review is concerned, however, that under this approach and that of *A New Tax System* the proposed upper limits on the amount of the concession will effectively become a floor and, in a very short time, it is likely that virtually all employees of tax-exempt bodies will be remunerated, taking advantage of this concession. The Review understands that under the arrangements prior to *A New Tax System* many tax-exempt bodies were not using the concession to the extent of the proposed limit. Now that it has been legitimised it will be clearly in their interests to reduce their employment costs by utilising the concession fully.

186 Where the tax-exempt body is engaged in business activity this tax break could provide them with a competitive edge over ordinary businesses. The Review is not convinced that the proposal in *A New Tax System* for a deduction for employees of tax exempts under its reforms will be sustainable in the longer term because of the eventual cost to revenue.

187 The Review considers that this element of government assistance to charities and the like should be removed from the tax system and replaced by a direct and indentifiable subsidy of an equivalent overall amount. A subsidy will be more transparent and deliver a better match between the intentions of government and the outcome. Addressing this problem now before it becomes more intractable and difficult has much to commend it.

Application of accounting concepts and principles

Subject to the overall objectives of tax policy there are clear advantages in more closely aligning tax and accounting treatments of transactions and assets

188 The Review has had regard to accounting principles and practice in formulating its recommendations and in many cases the proposals will move tax and accounting treatment much closer together. This will have significant benefits in terms of compliance. It will reduce the opportunity for taxpayers to pursue tax minimisation strategies on the one hand while attempting to maximise commercial outcomes on the other hand.

189 The Review is proposing that the ATO work with the accounting profession to identify differences in treatment. The future development of tax policy should continue to bear in mind the advantages of a closer alignment between the two systems, while recognising that the two are unlikely ever to be totally congruent.

Reinforcing integrity and equity

A better tax structure significantly reduces the need for specific anti-avoidance rules

190 The Review's recommendations will make a significant contribution to reducing tax avoidance through the removal of complexities and anomalies from the legislation and the adoption of a consistent approach to determining taxable income. This will remove many of the opportunities for taxpayers to avoid taxation through exploiting unintended loopholes in the law.

191 Tax avoidance needs to be distinguished from tax evasion on the one hand and sensible tax planning on the other. Tax evasion is illegal; it involves taxpayers undertaking actions which are expressly forbidden under tax or other legislation. Tax avoidance is not illegal and so is much harder to define. Tax avoidance could be characterised as a misuse of the law rather than a disregard for it. It involves the

exploitation of structural loopholes in the law to achieve tax outcomes that were not intended by the drafters of the legislation or by the Parliament.

192 On the other hand, tax planning could be characterised as ensuring that a taxpayer achieves the best treatment for his or her income which is available under the law, as it is intended to apply. To the extent that tax planning does no more than ensure that taxpayers are aware of, and can take advantage of, intended features of the law, it helps to ensure that the intentions of Parliament are implemented. However, the boundary line between tax planning and tax avoidance is obviously less well defined than that between tax avoidance and tax evasion.

193 The sounder structure to the law and the more consistent approach to issues, which will eliminate many sources of tax avoidance, have allowed the Review to recommend the removal of a number of specific anti-avoidance provisions in the current law.

Streamlined general anti-avoidance rule

A streamlined general anti-avoidance rule

194 Under the proposed approach to tax avoidance, a streamlined general anti-avoidance rule will operate within a defined policy framework. The components of this framework are:

- that structural reform should be the primary mechanism for responding to tax avoidance; and
- a preference for general, over specific, anti-avoidance rules where a non-structural response is adopted.

195 The Review also sees a role for the Board of Taxation in monitoring the policy guiding the implementation of anti-avoidance provisions and advising whether any amendments are needed. To that end, the Board may consult with taxpayers on appropriate responses to tax avoidance.

Franking credit trading

196 A number of anti-avoidance provisions relating to franking credit trading and dividend streaming are contained in the current law. It is important to distinguish between these two activities.

197 Where an Australian entity only has income that has been taxed in Australia there is no scope for dividend streaming. Resident shareholders receive fully franked dividends and the imputation system ensures that the ultimate tax on the income is at the resident shareholder's marginal tax rate. Non-resident shareholders are exempt

from DWT on the franked dividends they receive and so are effectively taxed at the company tax rate.

Allowing franking credit trading would be contrary to tax policy objectives

198 If franking credit trading were allowed non-resident shareholders could effectively sell their franking credits to residents. This would allow them to obtain at least a partial refund of the tax paid on Australian source income at the entity level and would not be consistent with the intentions of tax policy.

199 The situation is different if the Australian entity also derives foreign source income that is exempt from Australian entity tax because it is earned in a comparably taxed foreign country. Where dividend streaming is precluded, Australian entities must perforce distribute some of this income to Australian shareholders as unfranked dividends which are then subject to full rates of tax in the shareholder's hands. At the same time non-resident shareholders receive franked dividends but are unable to use the franking credits. The Review's response to this problem is set out later in the discussion of international taxation arrangements.

200 The Review accepts that there are sound arguments for preventing franking credit trading. Removing the current specific restrictions, and instead relying on the general anti-avoidance provision, would involve an estimated revenue cost of $300 million to $400 million per annum.

Franking credit trading restrictions are required but they need to be made less onerous for genuine commercial activity

201 The Review believes, however, that many of the current specific provisions on franking credit trading could be modified to reduce the impact on commercial transactions without any significant adverse impact on revenue. The Review is recommending an initial paring back of the undue breath of those provisions by measures to:

- reduce the ownership period to 15 days;
- further clarify what an 'at risk' shareholding means;
- reduce complexity and compliance costs for trust beneficiaries; and
- increase the threshold exemption from the provisions from $2,000 to $5,000 of franking rebates for individuals.

Alienation of personal services income

Employees are increasingly seeking to change the legal form of their income from salary and wages to business income in order to minimise tax

202 There is evidence of a significant and accelerating trend for employees to move out of a simple employment relationship to become unincorporated contractors or the owner-managers of interposed entities while not really changing the nature of the employer-employee relationship. This process is known as the alienation of personal services income and moves the income received by the unincorporated contractor or the interposed entity out of the PAYE tax system. The arrangements have had the practical effect of these taxpayers claiming

deductions not available to ordinary employees and, if there is an interposed entity, allows scope for income splitting. As the economic reality of the earning of their income is unchanged, their income should be taxed on the same basis as other PAYE income. This is consistent with the principle adopted by the Review that tax be levied on the basis of economic substance rather than legal form.

203 The effect of such arrangements on taxation can be nullified by treating for taxation purposes the income earned by personal exertion as akin to employment income and taxing it on that basis. This prevents the minimisation of income tax and protects the tax system from substantial revenue losses. The Review is recommending this approach to the alienation of personal income services in situations where there is a fundamental employer-employee relationship. There is no reason to interfere with the legal construct of these relationships which can be put in place for other than tax reasons. The Review is not proposing any changes to the contractual relationships. They can continue to exist and new ones be established. The only change is the way taxation will be assessed and collected.

Non-commercial activities

The ability of taxpayers to claim tax deductions for expenses associated with non-commercial activities associated with hobbies or lifestyle choices will be restricted

204 Some taxpayers pursue activities, as hobbies or for lifestyle reasons, which are non-commercial, but seek to claim the expenses against their other income. An example could be a professional person who has a property in the country mainly for recreational purposes but uses it to agist a small number of stock. Even though there may be no realistic prospect of the agistment activity earning a profit, the taxpayer may seek to claim all the expenses associated with the property and use the resultant deductions to reduce tax on their income from their professional activity.

205 Subject to a range of straightforward tests designed to prevent genuine but unprofitable small businesses being affected, the Review is proposing that losses arising from such activities will not be allowable against other income. They will only be able to be offset by income from like activities.

Losses and value shifting

206 The treatment of losses generally is a major issue in the business tax system. Under basic tax principles there is a clear case for immediate tax recognition of losses. The denial of immediate recognition of losses while taxing profits as they are earned significantly increases risks of investment and is a major non-neutrality in the business tax system.

207 No jurisdiction allows a tax refund in the case of losses, as opposed to offset against taxable income, because of the risk to revenue. Under a realisations based tax system taxpayers have an incentive to realise losses while leaving gains unrealised. The Review accepts that a more generous treatment of losses would involve an unacceptable revenue cost and would be likely to open major opportunities for tax avoidance. At the same time it has been cautious about proposals that would further restrict the availability of losses to taxpayers.

The same business test for the carry-forward of losses is to be retained

208 One example relates to the temporary duplication of losses and suggestions that the 'same business test' should be removed in order to prevent loss carry-forward whenever the majority ownership of a company has changed.

209 When a company has accumulated losses this is reflected in the price of its shares. If a shareholder sells those shares his or her taxable income is reduced to that extent. Consequently the losses of the company are recognised in the hands of the shareholder. However, the company still has those losses on its books and can use them to offset later profits and so reduce company tax.

210 At this point the losses have been recognised twice, once in the hands of the previous shareholder and once in the hands of the company. If the company income freed from company tax as a result of the losses is then distributed to the new shareholders it would be taxed in their hands as unfranked dividends and there is no longer any double counting of losses for tax purposes. Note that the losses are only ever duplicated to the extent that shareholders sell their shares in the company.

211 The same business test allows companies to carry forward losses where the majority ownership of the company has changed but it is still conducting the same business. In these circumstances the temporary duplication of losses can be quite significant given that most of the shares have changed hands. In such situations taxpayers — particularly members of closely held entities — may have an incentive to delay the distribution of income and the unwinding of the loss duplication as long as possible. This led to suggestions that the same business test should be abolished so as to prevent the carry-forward of losses in such circumstances and their temporary duplication.

212 In fact the same mechanism can lead to the temporary duplication of gains. In these circumstances the revenue is collected twice on the same income. The situation is only corrected when the retained company income is distributed and the shareholder subsequently sells the shares and obtains the tax benefit of the capital loss.

213 This type of problem is generally accepted to be endemic to a system of entity taxation. The Review has concluded that the problems arising from the temporary duplication of losses do not justify the adverse impact on shareholders of denying the loss carry-forward in cases where businesses satisfy the same business test but the majority ownership has changed.

214 Nevertheless, the Review is extremely supportive of measures intended to prevent tax avoidance practices such as loss cascading and value shifting.

Loss cascading to be addressed through consolidation and for majority owned groups

215 Introduction of the consolidation regime and abolition of loss transfer and rollover concessions outside consolidation will effectively deal with loss cascading within company groups. It is also proposed to prevent tax losses being duplicated through the disposal of loss assets between entities in the same majority-owned group.

216 CGT value shifting refers to arrangements which shift value out of assets, often to other assets. It allows the generation and realisation of essentially artificial tax losses while deferring taxation of gains by not realising the assets into which the value has been shifted. While the current law has provisions to address this problem, they are deficient in terms of coverage and complexity. They also involve high compliance costs.

217 The Review is recommending general value shifting rules to apply a comprehensive and consistent regime across the full range of transactions and entities. This will significantly improve equity and efficiency as taxpayers will be taxed more consistently on transfers of value, whether they occur by way of conventional realisation or by value shifting. The new provisions will avoid the need for a continuing stream of anti-avoidance amendments as new value-shifting transactions are detected.

Minimum company tax

Introducing a minimum company tax is tantamount to admitting that reform of the business tax system is not feasible

218 As part of the agreement the Government concluded with the Australian Democrats to secure passage of proposals to reform Australia's taxation system, the Treasurer agreed to refer to the Review for its consideration:

- the adoption of a 20 per cent alternative minimum company tax;
- measures to limit the use of company structures for personal services; and
- a review of the tax treatment of motor vehicle fringe benefits.

219 The Treasurer confirmed that the Review was already examining the concessional fringe benefits tax treatment of motor vehicles.

220 In relation to the second matter, the Review had already considered proposals in relation to the alienation of personal services income and the issue is discussed earlier in this report.

221 The motivation for an alternative minimum company tax (AMCT) springs from the fact that in some circumstances an entity's taxable income may be significantly less than its accounting income. An AMCT would be levied on accounting income or an adjusted taxable income. There are major components of accounting income which it would simply be inappropriate to subject to taxation. For example, many companies have substantial dividend income which has already been subject to company tax. Further, foreign source income is included in accounting income but, if it has been subject to a comparable tax rate in the source country, it is not subject to Australian tax.

222 Countries which have adopted a form of AMCT seem to have done so because they have not successfully been able to engage in fundamental reform of their tax system. This is the case in the US and Canada, the two countries which have an AMCT of this kind. The other three countries, Venezuela, Colombia and Pakistan, which have an AMCT, calculate the tax on revenue or assets, indicating that their income tax systems do not operate effectively.

223 An approach based on taxing amounts that would otherwise not be included in taxable income can only be justified on the basis of a judgment that these particular omissions from taxable income are inappropriate and should be overruled by the application of the AMCT. It would only be appropriate if our tax system is not to be made fundamentally sound.

224 A major focus of the Review's task has been to examine the basis on which the taxable incomes of businesses are calculated and a comparison with accounting income has been an important part of that analysis. The Review's recommendations will bring accounting income and taxable income closer together in a number of important respects. The most obvious example is the removal of accelerated depreciation.

225 However, in a number of other cases the Review has concluded that an accounting treatment would not be appropriate for tax purposes. For example, accounting practice uses accruals to a much wider extent than the Review believes would be appropriate for tax purposes.

226 If there are concessions in the tax system which are regarded as inappropriate the best approach is to address them directly rather than through an indiscriminate measure such as an AMCT. For example, an

AMCT might result in income freed from taxation by virtue of the research and development concession being subject to tax. To avoid such an outcome, specific measures would be required under the AMCT arrangements.

227 Any other existing measures would also need to be considered for exclusion. It is obvious that if such a process were followed the merits of particular concessions would have to be judged and a decision made about their treatment under the AMCT. This is, of course, the process followed in developing the definition of taxable income for company tax purposes. Unless different decisions were made in respect of the AMCT and the company tax — and it is difficult to imagine why this should be the case — then the point of the AMCT would disappear.

Applying a cashflow/tax value approach

Capital allowances

Implementing an effective life regime

Wasting asset regime is to be rationalised

228 The terms under which capital expenditures can be deducted for income tax purposes are central to the taxation of investment income. Under the cashflow/tax value approach this issue is dealt with by the rules on determining tax value at the end of each income year.

229 For wasting assets the tax value at the end of each income year will reflect the depreciation rules applying to that particular asset. The capital allowance in that year for that asset will be the difference between its tax value at the beginning of the year and its tax value at the end of the year.

230 The existing tax legislation contains 37 different capital allowance regimes. These are to be replaced by two regimes: an effective life regime for business generally and an optional simplified regime for small businesses.

231 Under the effective life regime the taxpayer will have the option of self-assessing the effective life of the asset but will need to be able to justify the effective life chosen. The asset will be depreciated over its effective life.

232 Other features of the proposed depreciation regime are:

- the taxpayer bearing the economic cost of the decline in the value of the asset will be entitled to the deduction;
- assets will be able to be written off using either the prime cost or diminishing value method; and
- if an asset is sold for more than its tax value the excess will be subject to tax in that year and if sold for less the difference will be deductible.

233 The Commissioner of Taxation has undertaken to review the current effective life schedule for assets so that taxpayers have an up-to-date guide to the likely effective lives of particular assets.

234 Special arrangements are proposed to reduce the compliance costs associated with depreciating low value assets. Wasting assets costing less than $1,000 can simply be combined in a pool and the total value of that pool will be written off at a diminishing value rate of 37.5 per cent per annum. The value of the pool will be increased when assets are added to it and reduced by any sale of assets from it. This approach will significantly reduce compliance costs for low value depreciating assets. Taxpayers will, however, be able to depreciate individual items if they elect not to use the pool.

235 The Review is also proposing that assets subject to depreciation will no longer be subject to the capital gains tax regime. This means that even if indexation were to remain a feature of that regime it will not apply to depreciable assets. This will simplify compliance significantly. It is unusual for a depreciable asset to be sold for more than its purchase price but in such circumstances the current regime would have allowed indexation for capital gains tax purposes. As a result many taxpayers felt obliged to keep records against this possibility.

Application to buildings and structures

Buildings and structures will be depreciable over their effective lives

236 A major change proposed by the Review is the incorporation of buildings and structures into the effective life depreciation regime. At present most buildings and structures are depreciable according to statutory lives on a coupon basis. This means that they are depreciated on the basis of their original cost without any regard to values established through subsequent sales.

237 Consequently many buildings and structures are depreciated at an inappropriate rate and the value of the deductions arising do not always accrue to the taxpayer bearing the economic cost of the decline in value.

238 The proposed regime will require that new buildings or structures be valued separately to the land on which they stand at the time of sale.

Calculating depreciation as for other wasting assets will result in a much more appropriate depreciation regime for these assets.

239 The ATO, in consultation with affected taxpayers, will establish guidelines on the effective life of buildings and structures of various types.

Application to mining and resources

Treatment of mining expenditures will be rationalised and brought more into line with other industries

240 The generalised approach to capital allowances has also been the basis of the Review's recommendations in respect of the mining and resource industries. The recommended treatment is to identify when expenditure involves the creation of an asset and then allow the asset to be depreciated in accordance with its effective life.

241 This approach has led to a recommendation to remove the statutory upper limits on the life of a mine. For a number of capital expenditures related to mining and quarrying the effective lives of the assets are effectively the life of the mine. The proposal is to allow taxpayers to self-assess the likely life of the mine and so allow these assets to be depreciated over that period.

Rationalisation of treatment of sale of mining and quarrying information

242 Receipts from the sale of mining or quarrying information will be included in the calculation of taxable income and the expenditures involved in obtaining that information will also be recognised. For example, the current limit on the deductibility of expenditure on acquiring information from another person is to be removed. Thus expenditure on information in relation to a mine or project judged to be viable at the time will be deductible over the life of the mine or project. In other cases it will be immediately deductible.

Exploration and prospecting expenditure will continue to be immediately deductible

243 Expenditure on exploration and prospecting will continue to be immediately deductible under the Review's proposals. The strict logic of the generalised approach would suggest that expenditure on unsuccessful exploration and prospecting would be immediately deductible, while successful expenditure would be written off over the life of the resulting asset. However, in many cases there may be significant delays before it is known whether the activity has been successful or before a mine is established. It is largely on the grounds of practicality that the current treatment is proposed to be retained.

244 Expenditure preliminary to the extraction of the minerals will be treated in accordance with the generalised approach. To the extent that the benefit of the expenditure will be realised in future years, it will be recognised as creating an asset and written off over the life of that asset. On the other hand, to the extent that the benefits are used up in the year the expenditure is undertaken it will be deductible in that year.

Financial assets and liabilities

245 There has been a long standing consultative process carried on by the Treasury and the ATO with private sector representatives in regard to developing more consistent and appropriate arrangements for the taxation of financial arrangements. The Review's recommendations address the major issues arising from that process.

246 The Review's key recommendations include proposals to achieve enhanced coherency and consistency in tax-timing treatments for derivatives and other financial arrangements, greater certainty at the borderline separating debt from equity, and comprehensive treatment of gains and losses from disposal and debt forgiveness.

Allowing elective market valuation

Taxpayers will be given the option of being taxed on financial instruments on a mark-to-market basis

247 For many transactions in financial markets the basis of measuring the gain or loss on the transaction in the audited financial accounts is mark-to-market. In such circumstances it may be convenient for tax to be levied on the same basis. This is likely to be particularly so where market makers may have a relatively balanced book on a mark-to-market basis but, if taxed on a realisations basis, their tax liabilities might be quite volatile due to timing mismatches in realisation.

248 The Review sees no grounds for denying taxpayers the option of valuing financial assets at mark-to-market for tax purposes provided the taxpayer takes a similar approach to all similar assets, and those transactions are identified as such at the time they are entered into and are accounted for on the same basis in the taxpayer's audited financial accounts.

249 A related issue has been the desire of many financial institutions to account for foreign exchange transactions for tax purposes on a retranslations basis. This falls short of mark-to-market in that only the impact of foreign exchange movements on the value of assets and liabilities is taken into account. Other changes in value are brought to account on an accruals or realisations basis. The Review sees no difficulty with allowing such an approach so long as it is applied consistently by the taxpayer to all relevant transactions.

Taxing financial arrangements on an accruals/realisation basis

Current arrangements for taxing financial instruments on an accruals basis will be extended and rationalised

250 The Review has taken a strong position generally against the taxation of unrealised gains. This position reflects concerns that taxing accrued but unrealised gains could cause cash flow problems for taxpayers and may result in taxpayers being taxed on gains which are ultimately never realised. The proposal for the accruals taxation of some returns on financial assets is an exception to that position. It represents a recognition that financial instruments can be readily constructed so as to provide deferred realisation of accrued gains and that the ready tradability of such instruments mitigates possible cash flow problems.

251 However, the Review's proposals will confine the taxation of returns to financial assets on an accruals basis to those instances where the returns, or elements of the returns, are known with a high degree of certainty. This greatly reduces the possibility of a taxpayer bearing tax on income which is ultimately never received. In some cases returns on assets may have two elements: a certain element represented by such things as fixed coupon interest payments, and an uncertain element relating to possible movements in market interest rates. In these cases the accruals regime will only apply to the certain element of the return. The uncertain element, be it a gain or a loss, will continue to be taxed on realisation.

252 The accruals regime will not apply to individuals and small businesses investing in financial instruments where there is not significant deferral of returns.

253 Consistent with the generalised approach, the Review is recommending comprehensive disposal rules that include recognition for tax purposes of the realised gain or loss on the partial or total defeasance of liabilities. Gains on forgiveness of debt will also be taxed subject to special offset rules to apply in cases of financial distress.

Recognition of hedges

The Review is not recommending general hedging rules

254 Many taxpayers employ hedging arrangements in order to manage market risk. Ideally the tax system should not unduly interfere with these arrangements. One solution would be for the tax system to identify both sides of a hedge and tax it on a consistent basis. However, the application of such an approach typically involves significant practical difficulties, leads to complex rules, and is not entirely successful in achieving its objectives.

255 The introduction of optional mark-to-market and the accruals/realisation approach will much more closely align the tax and commercial treatment of financial instruments and reduce the need for complex formal hedging rules in the tax system.

256 Consequently the Review is not recommending general hedging rules. It has been convinced however that there is a need for the tax system to recognise hedging arrangements in two sets of circumstances: internal hedges and hedging by gold producers of future production.

Internal hedging will be recognised for tax purposes subject to a number of safeguards

257 Internal hedging will be allowed between domestic business units of a taxpayer subject to certain conditions including that:

- the hedge is between a business unit which accounts for all transactions on a mark-to-market basis and another business unit which accounts for all its transactions under the proposed accruals/realisation regime; and
- the transactions between the two units are at arm's length.

Special arrangements will be introduced to facilitate goldminers hedging future production

258 Gold miners have sound commercial reasons for wanting to hedge future production sales to reduce uncertainties about future cash flows and to benefit from the contango that is a constant feature of the gold market. Taxation arrangements need to accommodate these legitimate commercial interests while ensuring that they do not allow opportunities for undue tax deferral. After extensive consultation with gold producers the Review's recommendations represent a compromise between these two objectives.

Debt/equity hybrids

The Review is recommending a more certain boundary line between debt and equity

259 Debt/equity hybrids can pose classification difficulties under the tax system because the tax treatment of debt and equity is different and unclear at the border. This is a particular problem when the returns from the hybrid instrument flow to non-resident shareholders.

260 In order to achieve greater certainty and simplicity, the Review is recommending that hybrids be classified for tax purposes as either all debt or all equity. Returns on a hybrid classified as equity will be frankable and taxed as dividends in the hands of the investor. Conversely, returns on a hybrid classified as debt will not be frankable, will be deductible, and will be taxed as interest.

261 Hybrids will be classified on the basis of a debt test. Non-converting instruments will be categorised as debt if, leaving aside the impact of any indexation factor, they provide the right to repayment of at least the amount originally invested within 20 years. For converting instruments a tougher debt test is to be applied. This will require that the net present value of expected future returns at least equals the amount originally invested.

Leases and rights

262 The Review's proposals will improve the treatment of leases and rights, remove some major areas of tax avoidance or minimisation but also correct some deficiencies in the current law which unfairly penalise taxpayers.

Leasing and other rights over depreciable assets between taxable entities

The Review's recommendations will not disturb 'routine' lease arrangements

263 'Routine' leases — essentially leases with equal annual rental payments, other than those involving high value items for long periods — will continue to be taxed on much the same basis as now. This will mean little change for short leases of most items of equipment.

'Non-routine' leases will be subject to 'sale and loan' treatment if accelerated depreciation is abolished

264 Non-routine leases are essentially those in relation to large value items where the lease is for a long period, or where the specified annual payments are not a good reflection of the economic benefits being transferred. If accelerated depreciation is abolished as recommended, such leases will be subject to a 'sale and loan' treatment which negates any tax-deferral benefits arising from the structuring of lease payments and removes tax disadvantage associated with up-front lease premiums.

If accelerated depreciation is retained, tax preference transfer will be allowed for 'non-routine' leases

265 Should accelerated depreciation be retained despite the Review's recommendations, 'non-routine' leases will receive cashflow/tax value treatment and not the 'sale and loan treatment'. This will address structuring of lease payments but will also enable the transfer of tax preferences through lower lease payments currently allowed in respect of taxable entities. This is of significant benefit to tax loss entities. It enables them to obtain the benefits of tax preferences immediately, rather than having them reflected in a larger tax loss which would not be recognised for tax purposes until the entity returns to profit.

Tax-exempt entities

266 The Review notes that the revenue cost of allowing tax preference transfer to tax exempt entities — many of them State and local government bodies — would be significant if accelerated depreciation was retained. However, any arrangements to prevent such transfer

inevitably involve the policing of poorly defined boundary lines and require the taxation authorities to make difficult, and often contentious, judgments.

Section 51AD to be abolished

267 The Review recommends that section 51AD be abolished, as part of a package of reforms relating to tax exempt leasing. The Review believes that the severe treatment of arrangements that are currently subject to section 51AD is unnecessary. The Review also believes that, providing appropriate structural measures are in place, leases and similar arrangements involving tax exempts should not be treated differently simply because they are financed using non-recourse finance.

If accelerated depreciation is abolished, there is still a need to address structuring of lease payments

268 If accelerated depreciation is removed as recommended, the Review believes that most leasing arrangements involving tax exempts should be taxed on the same basis as leasing arrangements between taxable entities, although a narrower definition of 'routine' leases should apply. However, service arrangements and leases of buildings involving tax exempts should receive the cashflow/tax value treatment, to address the potentially high cost to revenue from structuring of payments which could otherwise arise.

If accelerated depreciation is retained, arrangements for denying access to tax preferences by tax-exempt bodies to be rationalised

269 Should accelerated depreciation be retained, the Review is recommending that Commonwealth and State officials examine possible arrangements for replacing Division 16D, that would make the application of this restriction more consistent and transparent. The Review recognises that even improved legislative arrangements would necessarily remain relatively complex and uncertain in their application. The Review believes that a better long-term solution would be for the tax system to allow tax preference transfer to tax exempts and for the Commonwealth and State governments to come to some agreement about offsetting the revenue loss to the Commonwealth.

Offshore use of assets

Tax preference is to be denied for any assets used offshore except for where they are primarily used for non-leasing purposes

270 The Review is also proposing that tax preference transfer be denied in respect of assets used offshore except where the assets are primarily used for non-leasing purposes by an Australian taxpayer. This will ensure that assets used offshore for non-leasing purposes, such as planes in the fleet of Australian airlines, will not be denied access to tax preferences.

271 The abolition of accelerated depreciation will remove the need for such provisions.

Addressing the assignment of leases

Tax avoidance through the assignment of leases will be addressed

272 Tax avoidance through lease assignment arrangements will be prevented under the Review's recommendations. Under current arrangements lessors can arrange to receive the benefit of the accelerated depreciation on an asset in the early years of the asset's life but then assign the lease to a tax-exempt body when those benefits begin to be clawed back in the later years of the asset's life. The purchase of the asset is usually arranged through non-recourse finance. This has been a significant area of tax avoidance.

273 Structural reforms recommended by the Review will address these effects. These reforms include general debt forgiveness provisions and measures to prevent the use of the current balancing charge rollover provisions to minimise or avoid tax on depreciable assets. These measures, combined with the cashflow/tax value approach incorporated in the new legislation, should be effective in preventing tax avoidance through lease assignments. Pending the implementation of these structural reforms, the Review is recommending that all relevant benefits received on assigning a lease, including any associated debt or liability from which the assignor is relieved, be included in taxable income.

Unifying the taxation of other leases and rights

The proposed treatment of rights will enable expenditure on rights to be written off and will provide a more favourable outcome for grantors in some cases

274 Rights over non-depreciable assets will also receive a rationalised tax treatment under the Review's proposals to provide a fairer and more consistent treatment to taxpayers. This will allow, for example, some rights not currently deductible, except as a capital loss at the end of their life, to be written off over their life.

275 The treatment will also recognise that as the length of the right granted in respect of a non-depreciating asset increases, the granting of the right comes to more closely resemble a disposal of the asset, either in part or totally, and should increasingly be taxed on that basis.

Implementing a unified entity regime

Consistent treatment of entities including trusts

The Review's recommendations build on the Government's proposed reforms of the taxation of entities

276 In *A New Tax System*, the Government announced proposals to reform the taxation of entities. They included a consistent regime for taxing the income of entities, full franking of distributions, refundability of imputation credits, reformed tax arrangements for life insurance, consolidation of company groups and a consistent treatment of entity distributions. The Review was given the task of consulting on these

proposals and developing detailed proposals for their implementation in the light of those consultations.

277 A consistent treatment meets the investment neutrality principle of *A Strong Foundation*. The alternative of taxing companies more like trusts, and allowing tax preferences to flow through, is generally not feasible from a revenue viewpoint.

A consistent entity tax regime will not preclude some exceptions under the entities regime, such as Pooled Development Funds, and some trusts will be excluded as suggested in *A New Tax System*

278 The general principle is that trusts will be subject to the entity tax regime. Consistent with *A New Tax System*, there will be specific exclusions from the regime for trusts created or settled only as a legal requirement or subject to a legal test or sanction. This approach distinguishes such trusts from trusts created at a settlor's direction. Exclusions are also justified in other cases for practical reasons. In particular, bare trusts, constructive trusts, the bank accounts of minors, and stakeholder and purchaser trust arrangements will be excluded.

279 Moving to a consistent entity tax regime does not preclude the maintenance of entity-focused tax concessions, for example the Offshore Banking Unit regime, Pooled Development Funds, Film Licence Investment Companies and employee share acquisition scheme arrangements.

Imputation

The Review is recommending against the deferred company tax proposed in *A New Tax System*

280 *A New Tax System* proposed the achievement of full franking through the imposition of a deferred company tax (DCT). This would have required an Australian entity paying a dividend out of tax-preferred income to pay tax at the company tax rate on that income and therefore pay fully franked dividends as a result.

281 This proposal has been strongly opposed by business. One of the major concerns has been that any DCT paid would impact adversely on the after-tax profits of Australian companies. This would lead to negative perceptions by investors and impact adversely on share prices and the ability of companies to raise capital.

282 A second concern has been that the DCT would have sharply reduced the return available to foreign investors with further adverse effects on Australian companies and the competitiveness of Australia as an investment destination. The Review considered a proposal to offset this second effect through a DCT/dividend withholding tax switch. While this may have been an effective offset for most foreign investors, there would still have been adverse impacts on some investors. In addition, there is considerable uncertainty about the effectiveness of this measure in respect of possible reactions by other countries in terms of creditability of the Australian dividend withholding tax (DWT).

The Review is recommending the taxing of unfranked inter-entity distributions as an alternative to the deferred company tax

283 The alternatives to the DCT canvassed in *A Platform for Consultation* were a resident dividend withholding tax (RDWT) or taxing unfranked inter-entity distributions. After considering the outcome of consultations and further analysis the Review is recommending the taxing of unfranked inter-entity distributions.

284 The impact of both the RDWT and the taxing of unfranked inter-entity distributions was equivalent in many respects. However, the RDWT would have been more complex in its operation.

285 As noted above, *A Platform for Consultation* canvassed the possibility of a company tax/dividend withholding tax switch. This option was originally motivated by the need to offset the adverse impact of the DCT on distributions of tax-preferred income to non-residents. The taxing of unfranked inter-entity distributions does not raise the same problem but it would have been possible to still implement the switch. This would
have been of benefit to non-resident shareholders to the extent that it increased the proportion of Australian tax creditable in their home countries.

286 Further analysis revealed that a significant percentage of non-resident investors are tax exempt. These investors are currently generally exempt from Australian DWT. Removing their exemption, in order to implement the switch in a revenue neutral manner, could have led to negative perceptions about Australia as an investment destination. Hence the Review is not recommending adoption of the proposal.

The Review has endorsed the Government's proposals for the refund of imputation credits

287 The refund of imputation credits to complying superannuation funds, low marginal rate taxpayers and registered charities as proposed in *A New Tax System* has been endorsed by the Review. The Review's recommendations also address concerns that delays in paying such refunds may cause cash flow problems for taxpayers in some circumstances.

Distributions

A comprehensive definition of distributions

The Review is recommending a broad definition of distribution which will encompass virtually all transfers of value from an entity to a member in their capacity as a member

288 A consistent entity regime requires for its development a consistent definition of what constitutes a distribution. The Review proposes a broad definition of a distribution as occurring when value has been passed from an entity to a member of the entity in their capacity as a member. Consequently it excludes benefits passed to employees in their capacity as employees, even when they are also a member.

289 A broad definition of distribution is the simplest and most equitable means of taxing benefits provided by entities to members. Such a definition adds integrity to the tax system as it restricts the situations in which value can be shifted from an entity to a member without being subject to tax. The recommended definition will apply to the provision of loans, or goods and services, at less than fair value.

Shareholder discounts by widely held entities are to be exempt

290 The definition would imply that discounts on goods and services provided by a member discount scheme would be treated as a distribution and subject to tax in the hands of the member. The Review is conscious that a number of major companies have shareholder discount arrangements in place. In order to minimise disruption to these arrangements, shareholders will be allowed an exemption on distributions via discounts from widely held entities where the discount is reasonable in extent, and is in respect of goods and services which the entity sells to the public in the course of its business.

291 The Review is also recommending that benefits provided by an entity to a non-member are treated as a distribution to a member if the non-member is a member of an associate of the entity providing the benefit. The most obvious example of where this provision might apply is where the parent company in a private company group directs a subsidiary to pay benefits to the members of the parent company. The effect of the provision will be to tax the provision of the benefit as if it were a distribution by the subsidiary and the recipient were a member of the subsidiary.

292 Proportionate provision of membership interests will not constitute a distribution where they are not expected to change the total market value of any member's interests. Disproportionate provisions of additional membership interests for no, or inadequate, consideration will be treated as a distribution for tax purposes to the extent of the shortfall in value.

Applying a 'profits first' rule

A 'profits first' rule is to apply to distributions from entities

293 To have clear and consistent arrangements for identifying the nature of distributions from entities in order to determine their correct tax treatment is important.

294 The Review is recommending that a profits first rule apply to distributions from entities to members. Entities will generally be required to distribute all retained profits before distributing contributed capital. This will prevent entities extending the period of tax deferral in respect of retained profits or streaming contributed capital and profit distributions to members in accordance with their tax preferences. The current law contains complex anti-avoidance provisions aimed at constraining these types of activity but the adoption of the proposed rule will allow these provisions to be repealed.

Measuring contributed capital

295 All entities will need to maintain a contributed capital account for tax purposes. The account will allow for the accurate identification of capital contributed to an entity, and will replace the existing rules for companies that are based on using a company's share capital account. Retaining the share capital account approach is not feasible given the inclusion of trusts in the entity system and the adoption of a profits first rule.

Distributions upon cancellation of member interests

A slice approach to apply to the cancellation of member interests

296 Distributions related to the cancellation of member interests will be split into profits, taxed and untaxed, and components using a slice approach. A slice approach effectively takes the slice of the company's contributed capital and retained profits attributable to a member's interests and uses that to identify the components in the payment to the member.

297 With the exception of on-market buy-backs the distribution to the member will be treated as follows:

- the contributed capital component will be treated as proceeds on the disposal of the membership interest by the member;
- the taxed profit component will be a fully franked profit distribution; and
- the untaxed profit component will be an unfranked profit distribution.

298 For distributions related to on-market 'buy-backs' the entire amount will be treated as proceeds on the disposal of the membership

interest by the member. In on-market buy-backs members do not know the identity of the buyer of the shares and so this is the only practical treatment. The entity conducting the buy-back will benefit by being allowed a capital loss equal to the taxed profit component with no effect on the entity's franking account.

299 The current arrangements can involve double taxation in respect of on-market share buy-backs and liquidations and this will be eliminated under the Review's recommendations.

Life insurance and pooled superannuation trusts

300 The Government announced in *A New Tax System* major proposed reforms to the taxation of the life insurance industry. The Review has consulted widely on the basis of those proposals and its recommendations are broadly in line with the approach set out in *A New Tax System*. However, the recommendations include some transitional arrangements and a practical solution in relation to superannuation activities conducted by life offices intended to put them on an equivalent footing to superannuation funds.

A consistent taxation regime for life insurers

Life insurers will be taxed on a more rational basis in line with the treatment of similar activities by other entities

301 Existing taxation arrangements for life insurers are very complex with income and expenses being allocated to up to four classes of business.

- Each class is subject to a different rate of tax.
- Some classes include components which are exempt from tax or subject to different rates of tax.
- Different calculations are required to determine assessable income for each class of business.

302 Tax avoidance opportunities can arise from internal dealings that exploit differences in the taxation rates of each class of business.

303 Existing taxation arrangements for life insurers are inconsistent with the treatment of similar activities carried on by other entities.

- The income tax base does not include all income.
- Similar economic activities are subject to different rates of tax depending on whether the business is carried on by a life insurer or a general insurer. For example:
  - unlike general insurers, life insurers are not taxed on underwriting profit; and

- management fees embedded in premiums are not included in the assessable income of life insurers. However, all management fees are included in the assessable income of banks, public unit trusts and general insurers.

304 The Review is recommending that these discrepancies in treatment between life insurers and other entities be removed. This will mean that:

- the taxable income from the risk business of life insurers will be calculated on the same basis as the taxable income of the risk business of general insurers; and
- the taxable income of the investment business of life insurers will be calculated on the same basis that applies to calculate the taxable income of the investment business of other investment entities.

The Review is responding to industry concerns by proposing transitional arrangements

305 An issue raised by the industry in consultations was a concern that for some products already sold the changed taxation arrangements on the future income from those products would involve an element of retrospectivity. The argument is that in many cases expenditure incurred early in the product's life is related to earning income later in the product's life. Essentially many of the life insurer's expenses are incurred up front. Consequently changing the tax regime applying to the income where that regime did not apply at the time the expenses were incurred could be a form of retrospectivity.

306 The Review accepts that these early expenditures are related to earning income over the life of the product and consequently should be deductible accordingly. This approach should also apply to all new products sold after the date of effect of the new measures.

307 As a transitional measure the Review proposes that only two-thirds of management fees derived on existing life insurance policies will be taxable for the first 5 years of the new arrangements. This will provide some recognition of the up front expenses incurred in respect of those policies and provide some broad equivalence to amortisation in determining taxable income relating to the earnings streams from this business.

Taxation of superannuation business of life insurers

The Review's recommendations will allow life insurers to maintain their current role in respect of superannuation through the establishment of 'virtual PSTs'

308 For life insurers, the taxation of their superannuation business has also been a major issue. *A New Tax System* proposed that all the income of life insurers — apart from retirement savings accounts — be taxed at the company tax rate. This would have impacted on the superannuation business of life insurers. *A Platform for Consultation* recognised this and suggested that an efficient mechanism for ensuring prompt refunds of excess imputation credits in respect of investment returns assigned to superannuation funds would result in their effective tax rate of 15 per cent being maintained.

309 Reacting strongly to this proposal, the industry pointed out that about 80 per cent of the business of life insurers consists of complying superannuation business with around $123 billion of funds under management. The industry was concerned that the proposed approach would prevent tax-preferred income earned by life insurers being passed on tax free to superannuation funds. This would put them at a competitive disadvantage and result in the current business being transferred from the life insurance industry to pooled superannuation trusts (PSTs) or master superannuation trusts, involving the transfer of the $123 billion of securities and the resultant transaction costs.

310 The industry argued that the superannuation business of a life insurer should be taxed as a superannuation entity. The Review has recognised the force of this argument and that it accords with the general principle that similar activities should be taxed in a similar manner.

311 The Review is recommending that life insurers be able to set up a 'virtual PST' rather than having to transfer the existing pool of assets to a newly established PST, thus avoiding the disruption and costs which would be involved. Assets relating to existing complying superannuation business and deferred annuity business will then be transferred to the virtual PST. The virtual PST will be required to be treated as a separate entity within the life insurer with separate accounts. It will then be taxed on the same basis as other PSTs. This proposal will address the life insurers' concerns and avoid the expensive and difficult task of transferring assets to a separate legal entity.

Taxation of policyholders

Bonuses will carry imputation credits to reflect tax paid by the life insurer

312 *A New Tax System* also proposed that policyholders be taxed on the grossed-up amount of bonuses allocated to them with the imputation credits reflecting tax paid by the life insurer on that income being refundable to the policyholder. This will be an equivalent treatment to that applying to individuals investing through other entities. However, it raised the issue of how to deal with the possibility that policyholders may be taxed on bonuses allocated but not yet paid.

Policyholders will be allowed the option of having bonuses allocated annually and taxed at that time or on maturity and only taxed then

313 *A Platform for Consultation* (pages 740-743) canvassed three options and these were addressed in the consultation process. As a result the Review is recommending that life insurers will be able to offer policies that:

- allocate amounts for taxation purposes annually with the taxpayer paying tax at that time; or
- allocate amounts for taxation purposes only on the surrender or maturity of the policy with the taxpayers paying tax at that time.

314 It is anticipated that the first type of policy may be attractive to lower income taxpayers where the availability of refundable imputation credits will result in them receiving annual net refunds of tax under such policies. Conversely, higher income taxpayers will probably prefer the second type because it offers the same tax-deferral advantages as those gained when companies retain income rather than pay annual dividends.

Consolidated groups

Consolidation will allow a significant reduction in compliance costs for company groups while also reinforcing the integrity of the tax system

315 *A New Tax System* identified that the existing loss and asset transfer provisions for wholly owned groups of companies facilitated the creation of artificial losses and replication of losses in company groups. It is also possible for group companies to gain unintended tax advantages by dealing among themselves. Anti-avoidance provisions to address these outcomes are complex, adding to administrative and compliance costs, and have been unable to keep up with the growing adoption of various tax strategies aimed at achieving these kinds of undesirable outcomes.

316 In response, *A New Tax System* announced the Government's intention to consult with the business community on a move towards allowing wholly owned groups of Australian resident companies, fixed trusts and co-operatives to consolidate their tax position. The consultation was to be subject to the following principles:

- intra-group dealings would be ignored for the purposes of the group's tax assessment;

- eligible groups would be able to make an irrevocable choice to consolidate the whole group rather than have all entities in the group subject to separate tax treatment;
- the existing group concessions would be replaced by consolidation and, therefore, repealed;
- companies or trusts entering a consolidated group would be able to bring franking account balances into the group and also carry forward losses on a basis consistent with the principles underlying the existing law;
- exit provisions would determine equity cost bases for entities leaving a consolidated group by reference to asset cost bases and equity cost bases on entry and to any cost base adjustments necessary during consolidation; and
- companies and trusts exiting a continuing group would be unable to take carry-forward losses or franking account balances with them. The losses and franking account balances would stay with the continuing group.

The logic of allowing the tax system to ignore internal transactions is compelling

317 Consolidation clearly has the potential to deliver significant efficiency gains both to entity groups and the tax authorities. The logic of allowing the tax system to ignore what are essentially internal transactions appears compelling to the Review.

318 The Review is also recommending a more generous treatment for losses where entities consolidate. Broadly, an entity with carry-forward losses which satisfy the continuity of ownership test will be able to bring those losses into the consolidated group; the portion of the losses which relate to the group's interest in the entity at the time the losses were incurred may be claimed immediately, while the remaining amount may be claimed over 5 years.

319 Some submissions to the Review have argued for retention of the present system but have not shown how the acknowledged flaws to that system could be effectively overcome. Concerns about complexity commonly cite the US system as evidence. Complexity in the US derives from the 80 per cent ownership threshold for including subsidiaries in a consolidated group, and the consequent need to account for minority interests. The Review's proposal will require 100 per cent ownership for the purposes of consolidation and so the treatment of minority interests does not arise.

320 Business also raised a number of other concerns about the basic approach set out in *A Platform for Consultation*. There was concern about the need for a consolidated group to have an Australian resident head entity and some concerns about the possible treatment of losses.

321 The Review has addressed these concerns in its final recommendations.

Recognising direct investors and small business

Flow-through taxation

A specific regime for collective investment vehicles

322 The Review believes that it is very important that small investors have the opportunity to invest on the same basis and with similar opportunities for diversification as more wealthy individuals.

The CIV regime will put small investors on the same footing as direct investors

323 Wealthy individuals have the capacity to invest directly in a range of assets. If the returns from those assets are taxed on a concessional basis the direct investors retain the benefit of those concessions. Other individuals need to invest through a collective investment vehicle (CIV) in order to obtain the benefits of a diversified investment portfolio. However, if the CIV were to be taxed as an entity the benefits of any tax concessions would be 'clawed back' by the imputation system. This would place these individuals at a disadvantage compared with wealthier individuals.

324 In recognition of such problems the Review is recommending that investments through CIVs be taxed on a flow-through basis. Tax-preferred income distributed to members by CIVs will be exempt from taxation, placing these investors in the same position as those who invest directly.

325 Eligibility criteria will needed to ensure that CIVs do not use this tax treatment to compete unfairly with ordinary businesses carried on by entities. Entities wishing to qualify for CIV treatment will have to:

- be unit trusts;
- be widely held;
- have a single class of membership interest;
- invest only in 'eligible investment activity' — essentially passive investments;
- make a one-time election to be excluded from the entity tax regime; and

- distribute all, or virtually all, of their taxable income each year. Reinvestment arrangements will be allowed.

326 Income earned through a CIV will retain its character as, for example, capital gains, dividends or interest. This is particularly important for non-residents' investments in CIVs where different tax treatments can apply to different types of income.

Rationalising the taxation of partnerships and other joint activities

Current arrangements provide opportunities for tax avoidance

327 The current tax treatment of the assets of a partnership uses an entity approach for the purposes of depreciation in that the depreciation allowances are used in calculating the taxable income of the partnership each year. When a partnership disposes of a depreciable asset, it accounts for any balancing gain or loss arising from the disposal.

328 However, when an interest in a partnership is sold (for example, an outgoing partner sells his/her interest to an incoming partner), the approach is to treat the whole of the asset as being disposed of by the old partnership to the new partnership at its market value. Where the market value of the asset exceeds its tax value, that would result in continuing partners being taxed on unrealised gains in respect of their continuing interest in the assets. To alleviate that, optional rollover relief is provided which allows the gain to be deferred until the continuing partners' interest in the asset is sold.

329 Chapter 14 of *A Platform for Consultation* described the possibilities for using the rollover relief to permanently avoid tax on assessable balancing charges. It also described how the rollover relief allows for the transfer of unrealised losses and yet allows the outgoing partner to obtain a corresponding capital loss.

330 The problems with the rollover relief can be addressed by abolishing the current approach and instead requiring partners to use the fractional approach. Under that approach, partners separately account for their share in any partnership transactions and assets. That approach could, however, have significantly higher compliance costs, particularly for those partnerships with many individual assets and whose partners are continually changing. An alternative approach would be to modify the current entity approach by taxing disposals of interests in partnerships in a manner similar to the current treatment of disposal of company shares and trust units. That approach would resolve the problems with the rollover relief and should be simpler to comply with, but would introduce some tax timing disadvantages for taxpayers.

There will be the option of a fractional interest approach or a joint approach combining both fractional interest and a modified entity approach

331 To balance the need for integrity in the law on one hand and the cost of compliance for taxpayers on the other, the Review proposes that taxpayers be given the option of adopting either the fractional interest approach or a joint approach. This will allow some assets and transactions to be taxed under the fractional interest approach and others under a modified entity approach.

Small business initiatives

The Government imposes significant costs on small business through using them as unpaid agents

332 Small businesses with annual turnover below $1 million represent over 850,000 businesses. These businesses find the compliance costs associated with the tax system to be a major burden. Not only do they incur considerable costs in respect of their own business income, but they are also required to collect taxes in respect of their employees' income and carry out other functions on behalf of the Government.

333 The Review believes that the growing burden being placed on business through the Government requiring them to act as its unpaid agents is a significant issue. Businesses have to carry out in respect of their employees a number of functions on behalf of government which are not central to their operation. This includes such standard functions as collecting PAYE tax instalments, but can extend to other areas such as prescribed payments, reportable payments, superannuation guarantee contributions, fringe benefits tax, child support payments and Higher Education Contribution Scheme (HECS) contributions. In addition to these activities there is the further provision of statistical data to the Australian Bureau of Statistics and information related to social welfare such as separation payments.

334 Some of these functions, such as collecting PAYE instalments, are closely associated with the operation of the business. While this does not detract from the argument for recognising the costs the task imposes on small business, and that it is essentially a government function that is being performed, it does imply that continued collection by small business is likely to be the most efficient approach. In other cases, such as separation payments, HECS and child support payments, the case for small business carrying out these functions, even if they were adequately compensated, is less obvious.

335 In some cases these functions can generate a cash flow benefit which offsets to some extent the costs to the business of carrying out these functions. However, this is more likely to be the case for larger businesses and, in any case, the degree of any offset varies significantly. Small businesses tend to be particularly disadvantaged by the imposition of these government requirements.

336 The Review considered measures specifically aimed at compensating small business for the costs associated with carrying out these functions for government. However, the diversity of functions performed and the diversity of small business itself made it difficult to design an effective response that could be delivered efficiently through the tax system. The Review is firmly of the view that some recognition of this is justified and this was a supporting argument in favour of reducing small business costs directly associated with the business tax system.

Reducing the compliance costs of small business is a high priority

337 The Review is recommending that businesses with an annual turnover of less than $1 million be given the option of adopting a simplified tax system consisting of:

- a cash basis for recognising business income and cash based expenditure;
- a simplified, and more generous, depreciation system; and
- a simplified taxation treatment for trading stock.

338 Over 95 per cent of businesses have annual turnover below $1 million representing over 850,000 businesses. Table 5 shows the percentages of selected industries accounted for by businesses falling into this category.

Table 5 **Percentage of industry accounted for and amount of tax paid by businesses with annual turnover of less than $1 million**

Industry	%	$m
Accommodation, Restaurants and Cafes	90	139
Construction	97	1,324
Cultural and Recreational Services	98	122
Finance, Insurance and Business Services	96	3,167
Manufacturing	85	429
Primary Production	99	1,029
Retail	89	443
Transport, Storage and Communication	96	433
Wholesale	79	318

339 Small business proprietors must prepare and retain a myriad of documentation for taxation and other purposes and in doing so incur substantial labour and other costs. In addition, small businesses are less able to afford automated systems or convert to new systems because costs are high and considerable expertise is often required.

340 Allowing small businesses to determine their income and expenditure for tax purposes on a cash basis will reduce their compliance costs.

341 Small businesses which elect the cash basis of accounting will use simplified depreciation and trading stock systems. The simplified depreciation system will allow:

- an immediate write-off for wasting assets where the cost of each asset is less than $1,000;
- a pooling arrangement with a rate of 30 per cent (declining balance) for all other assets with an effective life of less than 25 years; and
- a write-off of pool balances of less than $1,000.

342 The simplified depreciation regime will significantly reduce record keeping requirements. It also provides an element of acceleration compared with the use of effective life depreciation. For those businesses which will not benefit from a reduction in the company tax rate this will provide some offset for the loss of accelerated depreciation.

343 The simplified trading stock system will allow:

- businesses with trading stock of less than $5,000 not to bring their trading stock to account; and
- any increase in the value of trading stock not to be brought to account until such time as the increase exceeds $5,000.

344 Once again the motivation is to reduce compliance costs of small business where this can be achieved at acceptable costs to other tax system objectives.

Rationalisation of CGT rollover and exemption provisions for small business

345 The Review is recommending that the existing CGT concessions for small business be rationalised. The current CGT rollover relief, the CGT retirement exemption, and the CGT goodwill exemption provisions all have the same underlying objective — that is to provide small business people with access to funds for expansion or retirement. These provisions are complicated and there is scope to merge and simplify them to make them operate more efficiently.

346 The recommendation will provide a 50 per cent exemption from all capital gains arising from the disposal of the active assets of a business with net assets of $5 million or less. The balance of the gain will be eligible for rollover into new assets or retirement. For individuals, the small business provisions will operate with respect to the CGT liability after the capital gain has been calculated under the proposed new arrangements for the assessment of capital gains. For example, if a small business person elects to take his or her gain on the 50 per cent reduction basis, the remaining 50 per cent of gain on active assets will be eligible for exemption and rollover.

Rewarding risk and innovation

Incentives for investing

The need for reform of Australia's capital gains tax was a major focus of submissions to the Review

347 Consultations have highlighted the current capital gains tax regime as an area of major concern to taxpayers. The Review believes that reforms to the current regime could substantially improve the operation of Australian capital markets and help support a stronger investment culture amongst ordinary Australians.

348 Australia taxes capital gains more harshly than most other comparable countries and certainly more harshly than other countries in our region competing for international investment. The competition for domestic and international capital for investment is strong and likely to become more intense. Failure to attract investment funds will mean lower levels of economic activity and fewer jobs.

CGT reforms for individuals and superannuation funds

The Review is recommending major reforms to the taxation of capital gains of individuals and superannuation funds

349 The Review's recommendations in respect of the capital gains tax regime for individuals will help to support a stronger investment culture amongst Australian households. The widespread privatisation of major public sector enterprises has greatly increased the number of Australian households owning shares. A less harsh CGT regime which encourages taxpayers to invest in such assets will help entrench and build upon these changes.

350 The Review is recommending that for individuals 50 per cent of the capital gain on assets held for a year or more will be included in the taxable income of the individual. Taxpayers will have the option of being taxed on this basis or on the full nominal gain above the cost base of the asset indexed to 30 September 1999. This will ensure that no taxpayer is taxed on capital gains at an effective rate in excess of 50 per cent of the marginal rate applying to other income.

351 Superannuation funds will be allowed the option of including in their taxable income two thirds of the nominal capital gain on each asset or full taxation on the nominal gain adjusted for any indexation accrued up to 30 September 1999.

Indexation and averaging is to be abolished

352 Funding this major reform will be revenue from the freezing of indexation, the abolition of the averaging provisions and increased realisations of capital gains as a result of the reduced taxation. The freezing of indexation will impact adversely on entities but they will receive major benefits from the reduction in the company tax rate. It is

also likely that the lower capital gains tax on shares and other membership interests held by individuals will impact favourably on the cost of capital for entities. The one third reduction in the effective tax rate on the capital gains of superannuation funds is designed to be a broad offset for the loss of indexation but has been set on the generous side.

353 As noted in *A Platform for Consultation*, the current averaging regime has led to unintended outcomes at considerable cost to the revenue and the equity of the tax system. The major reductions in the effective CGT rate on most capital gains reduces the need for any averaging. The highest rate for individuals will effectively be 24.25 per cent including the Medicare levy.

354 A number of submissions argued strongly for the retention of indexation and the Review notes that there will be some investments which would receive better treatment under the current system than under the proposed reforms.

Proposed changes will send a positive signal to investors

355 The choice comes down to a judgment about which system sends the more positive message to potential investors, both domestic and non-resident. The Review believes that a significantly lower rate for individuals and superannuation funds is more effective in this regard and so will make a more positive contribution to the development of Australia's capital markets and a stronger investment culture.

Capital market incentives

Venture capital

Australia's relatively harsh CGT regime impacts adversely on venture capital investments

356 Investments in start-up firms involved in high technology or innovative businesses typically provide investment returns in the form of capital gains. They also tend to be higher risk investments. Australia's relatively harsh capital gains tax regime impacts severely on the capacity of such firms to obtain investors in Australia. As a result, Australia loses many such firms as they move overseas to obtain investment for further development. This reduces the incentive for other innovative businesses to seek to develop in Australia, and Australia loses the spin-off advantages of having a growing community of high growth, innovative companies.

357 A further knock-on effect is that the development of an effective venture capital market in Australia is constrained. A vicious circle emerges as investors are reluctant to undertake high risk investment under Australia's capital gains tax regime, firms move offshore to obtain investment, and there are fewer examples of Australian success stories to encourage Australian investors.

Non-resident tax exempt investors to be exempt from capital gains tax on venture capital investments

358 Consequently the Review is recommending significant CGT relief for venture capital. Non-resident tax–exempt pension funds, such as US pension funds, will be allowed to invest in venture capital projects in Australia and be exempt from capital gains tax. This will provide US pension funds with the same tax treatment they enjoy in the US and so allow Australian investments to compete for funding on an even footing with US firms. The US allows Australian superannuation funds to be tax-exempt in respect of capital gains on investments in the US.

359 A more vibrant and successful venture capital industry in Australia will do much to encourage Australian investors to commit funds to these types of firms. The collective investment regime (CIVs) recommended by the Review will ensure that small investors have the opportunity to participate in such investments while diversifying the risk to acceptable levels. The scrip-for-scrip rollover relief recommended by the Review will also provide significantly improved incentives for this kind of activity to take place in Australia.

Scrip-for-scrip rollovers

360 The business community has long claimed that the absence of CGT rollover relief for scrip-for-scrip takeovers between companies was a major barrier to rationalising of Australian business and the realisation of significant efficiency gains.

Rollovers to be allowed for scrip-for-scrip transactions

361 Rollovers will be allowed for scrip-for-scrip transactions involving takeovers where at least 80 per cent of the target entity is held on completion and at least one of the entities involved is widely held.

362 This change is expected to allow a significant rationalisation of many Australian businesses with consequent benefits in terms of economic growth, returns to shareholders and employment. It will also allow start-up and early stage businesses to be acquired by widely held entities without triggering capital gains tax for the entrepreneurs until they realise their investments, thereby encouraging new ventures.

Responding to globalisation

363 The interaction of the Australian business tax system with the rest of the world is a crucial determinant of the international competitiveness of Australian business. Arrangements in this area need to strike a delicate balance.

Australian companies operating in global markets bring advantages to Australia

364 There are major advantages to Australia in Australian companies expanding overseas. The growth and diversification of Australian companies into world class businesses is clearly central to Australia's longer term economic development and it is important that the tax system is as supportive as possible of these developments.

365 The Review's recommendations are intended to ensure that Australian business is not hindered from expanding overseas and that Australia becomes a more attractive investment destination for both resident and non-resident investors. At the same time the Review has been conscious of the need to reduce opportunities for avoidance and evasion of taxation through the use of offshore arrangements.

Foreign investment brings major benefits to Australia

366 Clearly Australia is also entitled to tax income earned in Australia by foreign investors in recognition of their use of Government services and infrastructure and, in many cases, national resources. On the other hand, foreign investment brings major benefits to the Australian community through:

- increased levels of investment funding, higher economic growth and increased employment; and
- the provision of important linkages to the international economy in terms of technology, management expertise, and access to overseas markets.

367 With globalisation of economies becoming increasingly pervasive there will be increasing competition for the pool of investible funds in the international market and Australia needs to be able to attract an appropriate share of these funds in the interests of the whole community.

Australians investing offshore

368 A major concern of the Review has been the treatment of foreign source income of Australian companies. As Australian companies grow it is inevitable that they will earn increasing amounts of their income from overseas.

Providing an imputation credit for foreign DWT will mitigate the disincentive to resident entities to invest offshore

369 Foreign source income repatriated to Australia from comparably taxed countries is not subject to Australian company tax and so does not give rise to imputation credits. If distributed to resident shareholders, the foreign taxes are ignored and the distribution is subject to another layer of tax. This has the potential to discourage offshore investments that offer higher returns, and hence more benefit to Australian shareholders, than domestic investments. Furthermore, direct investments by residents in overseas entities are already allowed a credit for foreign DWT and this treatment is also available for trust

beneficiaries (and will be continued under the recommendations concerning resident CIVs).

370 The Review is recommending that Australia allow a credit for foreign DWT up to 15 per cent. This will mitigate the disincentive to resident entities to invest offshore and to repatriate dividends to Australia. It will ensure comparability of treatment with investments made by individuals directly into foreign companies or via CIVs.

371 The increased availability of franking credits as a result of the recommendation will improve the ability of Australian entities with foreign source income to pay franked dividends to Australian shareholders. However, some companies with a significant proportion of foreign source income will still find it difficult to pay fully franked dividends.

372 As a possible response, dividend streaming in respect of foreign source income would allow an Australian entity to direct dividends arising from foreign source income to non-resident shareholders and maximise the franking credits available to resident shareholders. This would reduce the disincentive for Australian companies to increase their overseas operations.

Dividend streaming would also mitigate the disincentive for overseas investment but would not benefit as large a range of companies

373 However, dividend streaming only benefits the Australian shareholders of those companies with both foreign source income and non-resident shareholders, and ideally in the same proportion. In fact, a company with foreign source income but few or no foreign shareholders would under dividend streaming, have an incentive to increase the proportion of foreign shareholders. This is because an increased proportion of foreign shareholders would allow a larger proportion of the dividends paid to the remaining domestic shareholders to be franked.

374 Streaming would allow the unfranked dividends to be directed to the foreign shareholders but would not improve the position of the foreign shareholders. This outcome arises because foreign source income paid to non-resident shareholders is exempt from DWT as a result of Australia's Foreign Dividend Account arrangements and franked dividends are also exempt from DWT. Consequently, non-resident investors are unaffected by any change in the mix of these dividends in their total dividend income.

375 The Review sees considerable merit in allowing foreign dividend streaming but the revenue cost is significant and so it has not been recommended.

Recognising imputation credits that initially flow offshore

376 At present a New Zealand company operating through a subsidiary in Australia can earn imputation credits. However, when the New Zealand parent company has Australian shareholders there is a case for recognising that and allowing the proportion of Australian earned income attributable to Australian shareholders to flow through the New Zealand parent to those shareholders with Australian imputation credits attached.

377 The Review is recommending that Australia propose such an arrangement to New Zealand on a reciprocal basis. That is New Zealand investors in Australian companies with New Zealand operations will also be allowed similar treatment in respect of New Zealand imputation credits.

Foreign investment in Australia

A better treatment for foreign investment in Australia

378 As noted earlier neither the proposals for the DCT nor the company tax/DWT switch canvassed in *A Platform for Consultation* have been recommended by the Review. The recommended alternative of taxing inter-entity dividends does not impact adversely on foreign investors as the DCT would have done.

379 The proposed CIV arrangements will also facilitate investment by non-residents. Income passing through a CIV will retain its character as dividends, interest, capital gains or other forms of income. This is particularly important for non-residents where different forms of income attract different taxation treatments, both in Australia and in their home jurisdictions.

380 Australia already allows so-called conduit income — foreign source income passing through an Australian entity to a non-resident investor — exemption from Australian tax where that income has already been taxed at an effective rate comparable to that imposed on Australian source income. The Review is recommending that these arrangements be broadened to allow wider and more effective exemption of conduit income. However, the exemption will still be dependent on the income having been comparably taxed.

Allocating income between countries

Thin capitalisation rules to be reformed

381 There are opportunities for companies to seek to transfer taxable income from one jurisdiction to another, for example by adjusting the gearing of investments. An investment in a high tax jurisdiction can be highly geared so as to minimise taxable income in that jurisdiction and maximise it in a low tax jurisdiction. It is common practice for countries to have thin capitalisation rules which limit the degree of gearing that is recognised for tax purposes.

382 Australia's current thin capitalisation provisions are not fully effective at preventing an excessive allocation of debt to the Australian operations of multinationals because they only address foreign-related-party debt and foreign debt covered by a formal guarantee, rather than total debt. The Review is recommending that the provisions have regard to total debt. At the same time it is recommending a safe harbour gearing ratio of 3:1 compared with the ratio in the current thin capitalisation provisions of 2:1 for the more restricted class of debt. The proposals will bring Australia more into line with other countries such as New Zealand and the United Kingdom.

383 It is also proposed to expand the thin capitalisation rules for Australian multi-national entities that have non-portfolio investments in controlled foreign entities.

384 The Review is also recommending that further consideration be given to personal taxation issues relating to foreign expatriates and departing residents. The objective would be to encourage further venture capital investment in Australia and promote Australia as a global financial centre.

Renegotiating Double Tax Agreements to be a priority

385 The renegotiation of Australia's Double Tax Agreement arrangements with a view to reducing the level of withholding taxes and generally updating the treaties should also be a priority.

Improving Australia's international taxation regime

386 International taxation arrangements are an extremely complex area and, given the time frame of the Review and the breadth of other business tax issues which had to be considered, the Review has not been able to fully address all the issues in this area.

387 A particular concern is whether there are remaining features of the current arrangements which impact on the decisions of entities to remain in Australia or to locate here in preference to other countries.

388 Another priority area should be a review of Australia's foreign source income rules which include the controlled foreign company, and foreign investment fund, measures.

389 Consequently the Review is recommending that there be an examination of Australia's policy in these areas to ensure that the internationalisation and expansion of Australian business are not impeded by inappropriate tax arrangements.