The Senate

Economics Legislation Committee

Provisions of the Taxation Laws Amendment Bill (No. 5) 2003

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CHAPTER 1

INQUIRY INTO THE TAXATION LAWS AMENDMENT BILL (No. 5) 2003

Background

1.1 The Taxation Laws Amendment Bill (No.5) 2003 (TLAB5) was introduced into the House of Representatives on 27 March 2003 by the Hon. Peter Slipper MP, Parliamentary Secretary to the Minister for Finance and Public Administration. At the time of preparing this report, the Bill remains at the second reading adjourned debate stage in the House of Representatives and has yet to be introduced into the Senate.

Purpose of the Bill

1.2 The Bill provides various amendments to the *Income Tax Assessment Act 1997*, the *Income Tax Assessment Act 1936* and the *Fringe Benefits Tax Assessment Act 1986*. The Bill contains eight schedules. Each schedule has the following purpose:

- amend the *Income Tax Assessment Act 1997* and the *Income Tax Assessment Act 1936* to implement changes to the thin capitalisation regime contained in Division 820-D of the *Income Tax Assessment Act 1997*. (Schedules 1 - 4);
- amend the *Fringe Benefits Tax Assessment Act 1986* to ensure that fringe benefits provided to employees of a public hospital will continue to be subject to the $17,000 capped FBT exemption, whether or not the hospital is a Public Benevolent Institution. (Schedule 5);
- amend relevant taxation legislation to reduce the effective rate of tax on the excessive component of an Eligible Termination Payment (ETP) paid by a superannuation fund. The amendments also provide a reduction in the amount of surchargeable contributions reported by the fund in respect of the relevant member. (Schedule 6);
- amend Division 165 of the ITAA 1997 to remove an anomaly that prevents a company from accessing the same business test to determine its eligibility to deduct a tax loss incurred in a previous year, or write off a bad debt, in circumstances where the company has failed the continuous ownership test but is unable to identify the precise date on which that failure occurred. (schedule 7); and
- amend the ITAA 1997 so that corporate tax entities will be able to choose the amount of prior year losses they want to deduct in an income year. (Schedule 8).

Reference of the Bill

1.3 On 18 June 2003, the Senate adopted the Selection of Bills Committee report No. 6 of 2003 and referred the provisions of the Bill to the Senate Economics Legislation Committee for report by 11 August 2003.

Issues for consideration

1.4 The Selection of Bills Committee identified the thin capitalisation provisions in Schedules 1 – 4 for consideration by the Committee, with particular reference to:

- the appropriateness of the test being the criteria of an internationally recognised rating agency;
- revaluation of assets;
- accounting standards; and
- $2 million threshold for the requirement to maintain records about an Australian permanent establishment.

Submissions

1.5 The Committee advertised its inquiry in *The Australian* on Wednesday 2 July 2003 and placed information about the inquiry on the Committee's internet website. It also wrote to a number of individuals and organisations, including the relevant government agency and Department, who were identified as possibly being interested in the Bill. They were alerted to the inquiry and invited to make a submission. A list of the parties from whom submissions were received appears at Appendix 1.

1.6 The majority of submissions addressed schedules 1 and 2, although several submissions also raised issues in relation to Schedule 6 (Eligible Termination Payments) and Schedule 8 (tax losses).

Hearing and evidence

1.7 The Committee held one public hearing on this inquiry in Parliament House, Canberra on Tuesday 29 July 2003. Witnesses who appeared before the Committee at that hearing are listed in Appendix 2.

1.8 Copies of the Hansard transcript are tabled for the information of the Senate. They are also available through the Internet at http://aph.gov.au/hansard.

Acknowledgment

1.9 The Committee is grateful to, and wishes to thank, all those who assisted with its inquiry.

CHAPTER 2

THE BILL

Inquiry scope

2.1 TLAB 5 is an omnibus bill containing 8 schedules. In accordance with the guidance provided by the Selection of Bills Committee, the Committee examined the thin capitalisation provisions in Schedules 1 and 2, restricting its examination of these to the four issues identified, specifically:

- the appropriateness of the test being the criteria of an internationally recognised rating agency;
- revaluation of assets;
- accounting standards; and
- $2 million threshold for the requirement to maintain records about an Australian permanent establishment.

2.2 The Committee also examined the two other issues raised in evidence:

- Schedule 6 (Reducing tax on excessive ETPs); and
- Schedule 8 (Tax losses).

The thin capitalisation regime

2.3 A 'thinly capitalised' entity is one that funds its assets through high levels of debt, with relatively little equity – that is, it is highly geared.

2.4 The 'thin capitalisation' rules are designed to prevent multinational taxpayers allocating an excessive amount of debt to their Australian operations. The rules prevent multinational entities from taking advantage of the different treatment of debt and equity to minimize their Australian tax.[1]

2.5 The rules restrict the deductability of interest paid by an Australian entity (ie: company, partnership or trust estate) on debts that it owes to a non-resident or a 'prescribed dual resident' entity that holds an interest in it. (for example, a debt-financed Australian subsidiary of a foreign company). [2] Deductions are only allowable if the debt to equity ratio does not exceed prescribed limits.

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1 New Business Taxation (Thin Capitalisation) Bill 2001, Explanatory Memorandum. p. 5.

2 CCH Australia Ltd, *Australian Master Tax Guide 2002,* p. 22-750.

2.6 Under the current law, the permissible debt to equity ration is generally 2:1, except in the case of financial institutions, where up to a 6:1 ratio is permitted.[3]

2.7 The current thin capitalisation provisions commenced on 1 July 2001, the previous provisions being extensively modified as part of the Government's reforms to the business taxation system following the Ralph review.

Who is subject to thin capitalisation rules?

2.8 The thin capitalisation legislation affects:

- Australian entities with certain overseas operations and their associate entities;
- Australian entities that are foreign controlled; and
- foreign entities with operations or investments in Australia

that seek to claim debt related tax deductions. The rules can apply to companies, trusts, partnerships, unincorporated bodies and individuals.

2.9 In administering the rules, the Australian Taxation Office distinguishes between '*outward investors*' and '*inward investing entities*'.

2.10 An *outward investor* is an Australian entity that:

- is an Australian controller[4] of an Australian controlled foreign entity; or
- carries on business through an overseas permanent establishment (such as a branch); or
- is an associate entity of either of the above.

2.11 An *inward investing entity* is either:

- an Australian entity controlled by a foreign entity (a *foreign controlled Australian entity*), or
- a foreign entity. Although all foreign entities are inward investing entities, the thin capitalisation rules only affect those that have Australian income-producing assets.

2.12 An example of the first type of inward investing entity is an Australian company that is a subsidiary of a United States company. An example of the second type of inward investing entity is a foreign entity that owns a rental property located in Australia.

2.13 Certain entities are exempt from the provisions. These include:

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3 CCH Australia Ltd, *Australian Master Tax Guide 2002,* p. 22-750.

4 The ATO defines an Australian controller as an entity with at least a 10% *thin capitalisation control interest* in an *Australian controlled foreign entity* or which otherwise has substantive control of an Australian controlled foreign entity. An example of an outward-investing entity is an Australian company that has a 51% shareholding in a New Zealand company

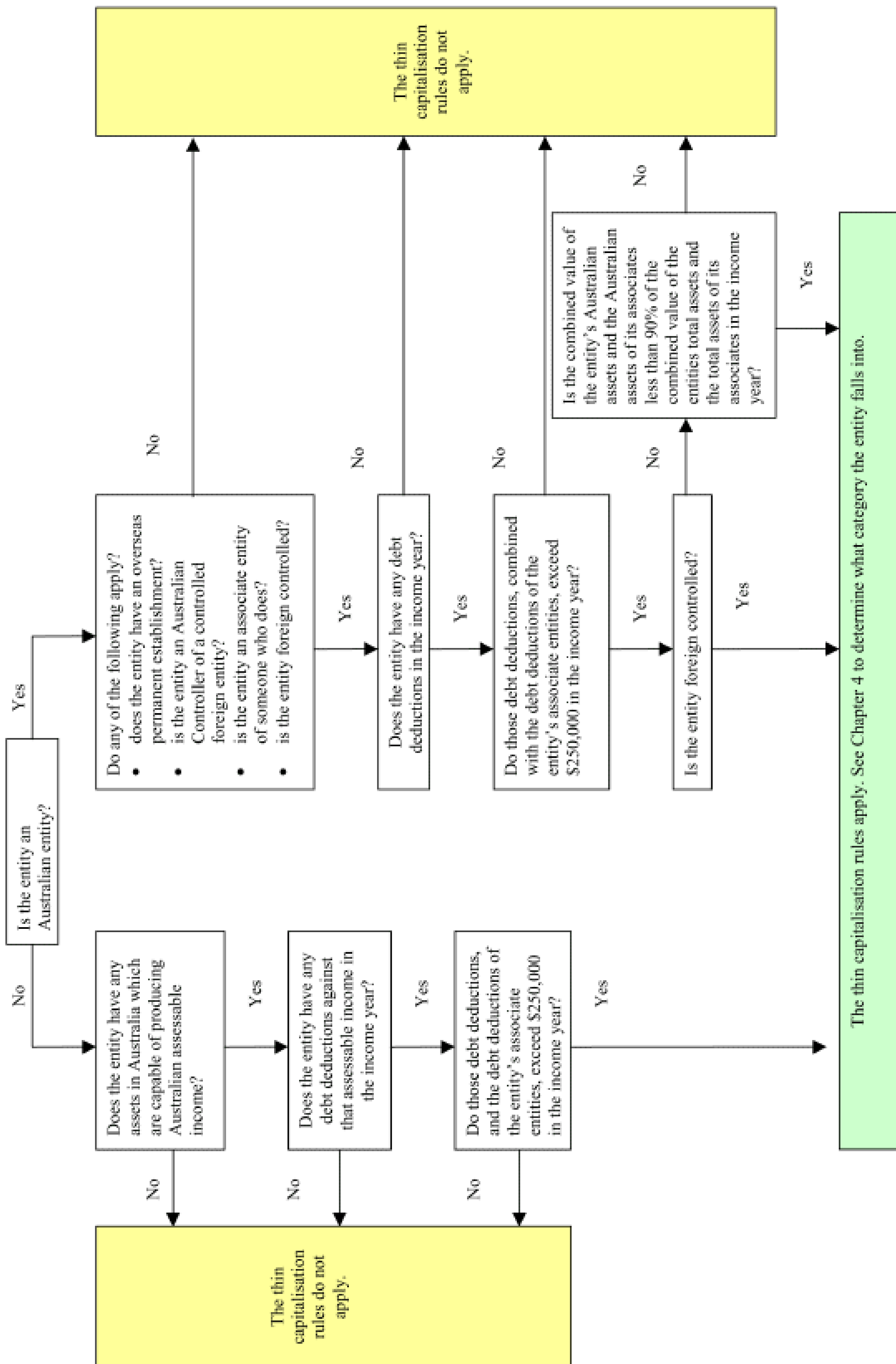
- entities that do not incur debt deductions for the income year;
- entities whose debt deductions (together with those of any associate entities) are $250 000 or less for the income year;
- Australian resident entities that are neither inward investing entities nor outward investors;
- foreign entities that do not have any investment or presence in Australia; and
- outward investors that are not also foreign controlled and meet the assets threshold test. [5]

2.14 The graphic at Table 1 provides a useful overview of how these rules work in practice.[6]

5 This section (paras 2.7 – 2.14 is derived from Australian Taxation Office, *The New Tax System – a guide to thin capitalisation*, p. 3 (as published on the A New Tax System website).

6 Sourced from ATO publication, Thin capitalisation: overview of the new thin capitalisation rules: Fact sheet.

Table 1:



Issues for inquiry

2.15 The issues identified for inquiry in the Selection of Bills Committee report were as follows:

- Internationally recognised rating agency test;
- Revaluation of assets;
- Accounting standards; and
- $2 million records threshold.

Internationally recognised rating agency test [7]

2.16 This Bill, will, if passed, exempt certain special purpose entities, in particular, '*securitisation vehicles*'[8] from the operation of the thin capitalisation regime.

2.17 The current legislation provides concessional treatment for securitisation vehicles. However, the definitions used for these vehicles have been found to be somewhat restrictive in their operation. As noted by Allens Arthur Robinson (AAR):

> The very restrictive definitions of 'securitisation vehicle' and 'securitised asset' in those provisions meant that a large number of bona fide securitisation structures would never qualify for the concession. This meant that the securitisation vehicle either had to attempt to rely on the vague and restricted 'arms length debt amount' rule or suffer the loss of interest deductions.[9]

2.18 The *Explanatory Memorandum* (EM) concurs with the AAR assessment, noting that many bona fide vehicles will inappropriately have a proportion of their interest deductions denied if the law is not changed.

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7 See *Explanatory Memorandum,* pp. 12 - 15.

8 A securitisation vehicle is a stand-alone financial entity that is designed to be financially sound (ie: bankruptcy remote) and independent of its sponsors. As explained by Mr Charles Armitage of the Australian Securitisation Forum, securitisation, in its simplest form, involves a financial institution selling some of its mortgages, mortgage loans or receivables to a special purpose entity. The vehicle acquires the loans using debt raised from third party investors through bonds - hence securitisation - issuing securities to fund the acquisition of those assets. This removes the assets from the financial institution's balance sheet and lowers the cost of the funds. (Source: derived from Transcript of Evidence, 29 July 2003, p. 10.)

9 AAR website publication: Tax deductibility of interest paid by securitisation vehicles.

2.19 Amendments contained in Schedule 1, item 2, subsection 820-39 of the Bill address this issue by setting three conditions under which special purpose entities can be exempted from the thin capitalisation rules:

- the entity is established for the purposes of managing some or all of the economic risk associated with assets, liabilities or investments (whether the entity assumes the risk from another entity or creates the risk itself);
- at least 50% of the entity's assets are funded by debt interests; and
- the entity is an insolvency remote special purpose entity according to the *criteria of an internationally recognised rating agency* applicable to the entity's circumstances.

2.20 The last of these conditions, the *internationally recognized rating agency test*, is one of the focal points for the Committee's examination of the Bill.

2.21 As explained in the explanatory memorandum, this condition seeks to ensure that the entity (ie: the securitisation vehicle) meets or would meet an internationally recognised rating agency's requirements for an insolvency remote special purpose entity (ie: that the possibility of the entity becoming insolvent is remote).

2.22 The *Explanatory Memorandum* notes that a rating agency may be satisfied about its prospective solvency where the entity can demonstrate that it:

- is restricted to activities necessary to its role in the transaction;
- is restricted from incurring additional indebtedness;
- cannot be subject to reorganisation, merger or change of ownership; and
- holds itself out to the world as a separate entity.

2.23 The application of this test requires the entity to be able to demonstrate that it could satisfy recognised international rating agency criteria but under proposed clause 4, it is not necessary for a rating agency to make a determination about whether the entity meets the criteria.

2.24 The EM notes that rating criteria vary. Some agencies publish general criteria whereas others have specific criteria for particular types of special purpose entities. Entities must be able to demonstrate that the particular set of criteria it chooses to use are appropriate to its circumstances.

Revaluation of assets

2.25 Under the current law, revaluation of assets is to be undertaken by an external expert valuer and conducted in accordance with accounting standards. Accounting standards form the basis of the existing provisions and the amendments will provide a number of variations from this requirement.

2.26 As described in the EM, the Bill, if passed, will modify the existing provisions in the following respects:

- relax the requirement for external expert valuations, permitting a suitably qualified employee to undertake the revaluation in accordance with accounting standards. However, an external independent valuer must review and verify the methodology used, including the validity of the underlying assumptions;
- allow the revaluation of a single asset in a class of assets provided that no asset in the class has fallen in value (a variation from accounting standards requirements); and
- permit entities to discontinue asset revaluation when the entity no longer wishes to use that revaluation for thin capitalisation purposes.

2.27 The relaxation of the revaluation provisions is offset by increased record keeping requirements when revaluing assets. An entity will be required to keep all records associated with a revaluation of assets under subsection 820-680(2). An exception to this obligation will be where the valuation is covered under subsection 820-680(2A).

2.28 The proposed amendments also clarify that where an entity undertakes a revaluation of its assets and that revaluation is reflected in its statutory accounts, those values can be used for thin capitalisation purposes.

Accounting standards [10]

2.29 The thin capitalisation rules require an entity to comply with accounting standards when determining the value of its '*assets, liabilities and equity*'. However, these terms are not defined in the current legislation, and accordingly their normal legal meaning applies. As noted in the EM, this leads to a number of difficulties:

- some assets or liabilities not being able to be valued using the accounting standards; or
- some balance sheet items might not meet the normal legal meaning of asset or liability.

2.30 The proposed amendment to subsection 820 – 680 (1), in schedule 3, item 16 of the Bill, inserts a clause making it clear that the accounting standards are to be used to determine the definitions of assets and liabilities.

2.31 A further proposed amendment at item 17 will insert an additional provision to remove any doubt that the requirements of subsection 820-680(1) to value assets and liabilities in accordance with accounting standards only covers those assets or liabilities that, according to the accounting standards, can or must be recognised at the relevant measurement time.

10 See *Explanatory Memorandum,* p. 33, under the heading 'Assets and Liabilities'.

$2 million records threshold[11]

2.32 The current legislation requires all foreign investors carrying on a business in Australia to prepare separate financial statements for their permanent establishments, in accordance with the Australian accounting standards. However, there is a provision for the Commissioner of Taxation to waive all or part of an accounting standard if the Commissioner decides that it is unreasonable for the entity to comply with that standard.

2.33 The proposed amendments in schedule 2 item 2 will exclude from these requirements entities with a permanent establishment in Australia where the total revenue attributable to that establishment is less than $2 million.

2.34 Entities must still satisfy record keeping requirements but may elect to use the accounting standards of this country or those of Australian accounting standards or the accounting standards of Germany, Japan, France, USA, UK, Canada, New Zealand or the international accounting standards.

2.35 The EM notes that the amendments are intended to reduce compliance costs for taxpayers and minimise ATO administrative arrangements in relation to the record keeping requirements.

2.36 In its submission to the Committee, Treasury notes that neither it nor the ATO expect any adverse revenue consequences from this provision:

> Neither Treasury nor the Australian Taxation Office has concerns that this will provide an avenue for tax minimisation or avoidance for overseas entities operating in Australia at or through permanent establishments. The amendment only affects some additional record keeping requirements. It does not affect the tax liabilities of entities operating permanent establishments in Australia, nor does it affect information that has to be supplied in tax returns, nor does it affect the records that taxpayers must keep, for example, to substantiate deductions.[12]

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11 See *Explanatory Memorandum,* p. 26.

12 *Submission 3*, p. 7.

CHAPTER 3

ISSUES

Overview

3.1 Almost all of the evidence received by the Committee supported the thin capitalisation measures proposed in the Bill. The Australian Securitisation Forum told the Committee that that the exemption for securitisation vehicles contained in the legislation is 'absolutely critical' to the continued viability of the securitisation market in Australia, which 'facilitates the provision of competitively priced finance to Australian home owners as well as commercial borrowers'.[1]

3.2 A recurrent theme in the evidence received was that the measures were the result of extensive and careful consultations between the Treasury and the financial sector.

3.3 Several submissions and witnesses reacted to prospective amendments to Schedules 2, 6 and 8 of the Bill, foreshadowed in the House of Representatives by Mr David Cox, the Assistant Shadow Treasurer. Witnesses and submittors argued against these amendments, urging that the schedules be passed without amendment.

3.4 This Chapter canvasses the issues that were raised in submissions and evidence, commencing with the four issues identified by the Selection of Bills Committee:

- Internationally recognised rating agency test;
- Revaluation of assets;
- Accounting standards; and
- $2 million records threshold.

3.5 The Committee then continues with a consideration of the other issues raised in evidence, specifically:

- Commencement date of Schedule 2;
- Reducing tax on excessive ETPs (Schedule 6);
- Tax loss provisions (Schedule 8); and
- Branches and debt deductions (raised by the Institute of Chartered Accountants in Australia (ICCA).

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1 *Submission 5.*

Internationally recognised rating agency test

3.6 The proposed amendments in the Bill would exempt certain special purpose entities, in particular, '*securitisation vehicles*' from the operation of the thin capitalisation regime.

3.7 The *internationally recognised rating agency test* is one of three conditions under which special purpose entities can be exempted from the thin capitalisation rules. Under this test, the entity must be able to demonstrate that it meets or would meet an internationally recognised rating agency's criteria for an insolvency remote special purpose entity. The test used must be applicable to the entity's circumstances. However, it is not necessary for a rating agency to make a determination about whether the entity meets the criteria.

3.8 The proposal in the Bill received support from those submittors and witnesses who addressed the issue. A comprehensive submission received from the International Banks and Securities Association of Australia emphasised that the criteria established by the international rating agencies are appropriate as a benchmark against which to assess a securitisation program for thin capitalisation purposes. The Association told the Committee that the credibility and integrity of these criteria is reflected in their acceptance by regulators in Australia and other countries.[2]

3.9 The Committee does not doubt the credibility of the criteria. A separate issue, however, is whether the appropriate criteria will be used by entities.

3.10 The Committee notes that the Bill includes a number of provisions designed to ensure that this test is not misused, for example, by using criteria that are not applicable to the entity concerned. As noted in the Treasury submission, the Tax Commissioner may determine that the criteria being relied on by an entity are not applicable to its circumstances and subject to appeal, impose criteria that are considered to be appropriate.[3]

3.11 The Committee considers that the safeguards are adequate and considers that these provisions should stand as printed.

Revaluation of assets

3.12 Under the current law, revaluation of assets is to be undertaken by an external expert valuer and conducted in accordance with accounting standards. The bill, if passed, will permit a suitably qualified employee to undertake the revaluation in accordance with accounting standards.

3.13 The proposal in the bill received general support from witnesses and submittors. The Corporate Tax Association of Australia noted that the current

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2 *Submission 6*, p. 1.

3 *Submission 3*, p. 3.

requirement to engage external experts imposed significant compliance costs, a full revaluation potentially costing 'hundreds of thousands of dollars'. Aware that the shift to in-house revaluations might lead to perceptions of conflicts of interest, the Association highlighted the requirement that an external expert still had to review and agree on the methodology used, commenting that this 'strikes the right balance between compliance savings and integrity concerns'.[4]

3.14 Evidence provided by the Treasury reiterated the integrity measures built into the bill:

> …the integrity of the valuation is maintained by the additional requirements, specifically by requiring:
>
> - validation by an external expert; and
> - detailed records that support the revaluation.[5]

3.15 Treasury confirmed that the revaluation must be verified by an external expert, that is, a person who does not have a conflict of interest in verifying the revaluation.

3.16 Treasury advised the Committee that the amendments in the bill also imposed extra record keeping requirements, covering the methodology for revaluation, its application, including the data and other information used, and the qualifications and remuneration of the valuer.[6]

3.17 The Committee accepts that the integrity measures in respect of revaluations incorporated in this bill are sufficient and considers that the provisions in the Bill should stand as printed.

Accounting standards

3.18 The thin capitalisation rules require an entity to comply with accounting standards when determining the value of its '*assets, liabilities and equity*'. However, these terms are not defined in the current legislation, and accordingly their normal legal meaning applies.

3.19 Again, evidence generally supported the changes proposed in the legislation, confirming the inconsistencies and impracticalities described in the *Explanatory Memorandum.*

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4 *Submission 1*, p. 2.

5 *Submission 3*, p. 4.

6 *Submission 3*, p. 5.

$2 million records threshold

3.20 The current legislation requires all foreign investors carrying on a business in Australia to prepare separate financial statements for their permanent establishments, in accordance with the Australian accounting standards. The proposed amendments in schedule 2 will exclude from these requirements entities with a permanent establishment in Australia where the total revenue attributable to that establishment is less than $2 million.

3.21 Again, this provision was generally supported. The Corporate Tax Association was amongst those who reflected the view that, in global terms, the turnover threshold of $2M is relatively small, observing that there is limited opportunity for avoidance where turnover is at this level. The Association saw the change as beneficial, making Australia a more attractive place to invest.[7]

3.22 The Institute of Chartered Accountants also welcomed the change, arguing that:

> …even an insignificant presence in Australia by an inward investor that falls within the definition of a permanent establishment requires the preparation of separate financial statements … Such a burden on small permanent establishments of overseas investors is, we submit, inappropriate and unnecessary, particularly during the start-up phase of a new business venture…[8]

3.23 Treasury advised the Committee that the Commissioner of Taxation already has a discretion to waive the requirement and that the $2M *de minimus* rule supplements that discretion.[9] The measure proposed in the bill is proposed, at least in part, to reduce unnecessary administrative burdens that might otherwise occur in the ATO if each individual taxpayer applied to waive the requirements.

3.24 Treasury also pointed out that the $2m revenue threshold proposal replaces and simplifies the current provisions, that require entities to have at least $250 000 of interest deductions before the thin capitalisation rules apply. Treasury argued that the proposal in the bill was simpler, and had ‘some commonality with thresholds in other areas of tax law for similar sorts of requirements’.[10]

3.25 The Committee notes that neither Treasury nor the ATO expect any adverse revenue consequences from this provision:

> Neither Treasury nor the Australian Taxation Office has concerns that this will provide an avenue for tax minimisation or avoidance for overseas

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7 *Submission 1*, p. 2.

8 *Submission 2*, p. 6.

9 *Submission 3*, p. 7.

10 *Proof Committee Hansard*, p. 22.

> entities operating in Australia at or through permanent establishments. The amendment only affects some additional record keeping requirements. It does not affect the tax liabilities of entities operating permanent establishments in Australia, nor does it affect information that has to be supplied in tax returns, nor does it affect the records that taxpayers must keep, for example, to substantiate deductions.[11]

3.26 The Committee is of the view that the provisions relating to the $2m records threshold should stand as printed.

Reducing tax on excessive ETPs (Schedule 6)

3.27 Several submissions and witnesses expressed concern about an amendment to this provision proposed in the House of Representatives.

3.28 The Corporate Tax Association noted, for example, that the broad impact of the bill would be to cap the tax rate on the excessive component of an Eligible Termination Payment (ETP) to no more than the top marginal rate of 48.5 per cent. However, if the proposed amendment passed, the rate of tax on an ETP could be considerably higher.[12]

3.29 Committee members pursued this matter with Treasury officers, pointing out that low income earners often face much higher effective rates of marginal tax, as they are affected by both a higher tax rate and a loss of welfare benefits if their incomes increase.

3.30 In response, Treasury advised that this measure, if passed, will only apply to superannuation eligible termination payments, and would not benefit 'golden handshakes'. Treasury acknowledged that some groups in the community might raise concerns about high effective marginal tax rates, but 'it is a policy decision for the government as to where they focus their attention'.[13]

Commencement date of Schedule 2

3.31 The Corporate Tax Association drew to the Committee's attention an amendment proposed in the House of Representatives to change the commencement date for schedule 2 from 1 July 2002 to 1 July 2001. The Association maintained that this amendment would amount to 'ambushing some companies with a law change that they could not have anticipated and can now do nothing about'.[14]

3.32 The Association pointed out that most of the changes were not announced until late 2002, and making them apply from a prior date meant that the affected

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11 *Submission 3*, p. 7.

12 *Submission 1*, p. 3.

13 *Proof Committee Hansard*, p. 26.

14 *Submission 1*, p3.

taxpayers would not have any opportunity to respond appropriately, for example by increasing their local equity. The Association expressed its opposition to this prospective amendment in strong terms:

> It has always been a general principle of tax policy and law design not to introduce legislation that is detrimental to taxpayers on a retrospective basis. Senators are strongly urged to vote against this proposed amendment.[15]

3.33 The Committee sought information from Treasury officers about the differential start up dates. Officers indicated that the Corporate Tax Association's arguments were sound:

> At the time of that announcement the minister said they would basically apply to the current income year and later income years, meaning from 1 July last year. We fully agree with the comments made by the Corporate Tax Association as to the reasons it was not appropriate to go back in those circumstances to the preceding income year or to income years about to be completed. There is simply no time for taxpayers to adjust in those circumstances to measures that could have some serious implications in individual cases for their financial structure.[16]

3.34 The Committee agrees, and is of the view that the proposed commencement date of Schedule 2 should stand as printed in the Bill.

Tax losses (Schedule 8)

3.35 The prospect that Schedule 8 might be deleted from the bill, as foreshadowed in amendments proposed in the House of Representatives, caused considerable concern among those witnesses and submittors who addressed this schedule. All of the evidence received by the Committee supported this schedule passing without amendment and expressed concern that this might not be the case. Of particular concern were the implications for companies that had already entered consolidation, an irrevocable decision, in expectation that the Ralph reforms package was assured of implementation.

3.36 The evidence of the Institute of Chartered Accountants in Australia (ICAA) illustrates the nature of the concern expressed. The Institute emphasised that

> …schedule 8 is an important and in fact critical element of delivering tax consolidation reform to Australia. Schedule 8 may have some other issues attached to it, but if schedule 8 is not passed then the net outcome for consolidating groups in Australia will be that many of them will have a tax trap introduced: a punitive taxation which will disadvantage them.[17]

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15 *Submission 1*, p. 3.

16 *Proof Committee Hansard*, p. 25.

17 *Proof Committee Hansard*, 29 July 2003, p. 3.

3.37 The Institute made a detailed and persuasive submission to the Committee which explained in clear terms the implications for companies of the Senate not passing the tax loss provisions in Schedule 8.[18]

3.38 A submission received from Ernst and Young also emphasised the importance of ensuring that the full package of measures associated with consolidation is passed by the Parliament. This submission contended that the measure in schedule 8 is 'critical in order to achieve a just and equitable outcome for corporate groups which are consolidating', noting that consolidation is 'commercially not optional' for corporate groups. The submission claimed that without the measure, there was the prospect of 'significant commercial damage'. Like the ICAA, Ernst and Young noted that the Ralph Review had unambiguously recommended that the issue of prior year tax loss erosion be addressed.[19]

3.39 Given the emphasis placed by a number of witnesses on the importance of Schedule 8 tax loss provisions for consolidation, the Committee asked Treasury officers why these provisions had not been included with the consolidation package, but were delayed until the introduction of this bill. Treasury responded that a judgement had been made that the tax loss provisions were more appropriately grouped with the imputation reforms in TLAB5:

> It links to two packages of reforms that were going on at the time. One of them was the simplified imputation system; the other was consolidation. The simplified imputation system had an impact as well because we changed the intercorporate rebate with a franking rebate similar to that which we apply to individuals and other taxpayers. In the end, a decision was taken that this measure was more an imputation issue than a consolidation issue, even though there were some linkages. Even though they had similar start dates in terms of legislative drafting and so on, they were on different timeframes and, with this one, the imputation measures are still being rolled out. Part of that is just because of the size of the package and so on, and this was one of those measures.[20]

3.40 The Committee questioned witnesses about the financial impact on the revenue of the consolidation measures, noting that this measure had been expected to cost $1B. Members foreshadowed that they considered the measure might need to be reconsidered if the Schedule 8 changes would add to this overall cost.

3.41 The Committee urges cautious consideration by the Senate of any proposal to remove Schedule 8. On the basis of the evidence received, such an amendment may have serious financial implications for many companies. These companies may well be entitled to feel that they have been significantly misled if they have locked

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18 Similar concerns were also expressed by the Corporate Tax Association of Australia (*Submission 1*, p.4.) and the Insurance Australia Group (*Submission 7*, p.2).

19 *Submission 5*.

20 *Proof Committee Hansard*, p. 24.

themselves into consolidation in the expectation that the measure proposed in Schedule 8 would be implemented. The Committee is of the view that Schedule 8 should not be deleted but should stand as printed in the Bill.

Branches and debt deductions

3.42 The ICAA drew the Committee's attention to what it considered was an unintended consequence in relation to the record keeping requirements regarding branches in Subdivision 820L of the ITAA and the *de minimis* exemptions in sections 820-35 and 820-37. The Institute proposed that the *de minimus* exemptions in Sections 820-35 and 820-37 of the Income Tax Assessment Act 1997 be extended to cover the record keeping requirements in Subdivision 820L.

3.43 The Committee was unable to come to any view on this issue but flags it for the possible attention of the Government, should it judge any further amendment to be required.

RECOMMENDATION

4.1 The Committee recommends that the Bill be passed.

SENATOR GEORGE BRANDIS
Chairman

Senate Economics Legislation Committee

Labor Senators' Minority Report

Taxation Laws Amendment Bill (No.5) 2003

Schedule 1, Part 2

To qualify for the carve out from the thin capitalisation rules a securitisation vehicle must, amongst other things, be an insolvency remote special purpose entity according to the criteria of an internationally recognised rating agency.

The securitisation vehicle need not be rated by the agency, only that it meet appropriate criteria of an internationally recognised rating agency.

It was argued before the committee that this arrangement had been negotiated over an extensive period and its passage is necessary to remove uncertainty.

It is unusual for eligibility for certain tax treatment to be determined by criteria prepared by a third party, with those criteria subject to dispute by the Tax Commissioner.

It would be normal to have the criteria set out in legislation, regulations, or a ruling by the Tax Commissioner.

Witnesses representing the interests of business and the financial markets argued that innovation in these areas is rapid and that it would be difficult for government processes to keep pace with developments and that is why the criteria of internationally recognised rating agencies are preferred by them.

An issue raised by the Committee but not adequately addressed by witnesses, is the risk that there may be rating agencies operating in the market, and therefore recognised, producing criteria of questionable quality, possibly for the purpose of attracting securitisation vehicles as subscribers, or even for the purposes of getting around the thin capitalisation rules.

It was pointed out that the Tax Commissioner would be able to dispute the appropriateness of the criteria, but that would almost inevitably give rise to a dispute and litigation.

Some quality control and additional certainty could be provided by an amendment to the bill to require listing by regulation those internationally recognised rating agencies whose criteria would be considered for the purposes of the thin capitalisation carve out for securitisation vehicles.

Recommendation

That the government consider amending the bill to provide for regulations listing the internationally recognised rating agencies whose criteria would be considered for the purposes of the thin capitalisation carve out for securitisation vehicles.

Schedule 1, Part 4

The bill allows a departure from standard accounting practice by allowing the revaluation of only one asset in a class instead of all assets in that class, provided no asset in the class has fallen in value.

It should be noted that the bill also provides for revaluations to be done in-house, although with an external independent expert validating that process.

The purpose of these measures is to provide a reduction in compliance costs.

It was agreed by witnesses there is a trade off between reducing compliance costs and ensuring compliance.

The logic for the departure from accounting standards of not revaluing all assets in a class was described by Treasury in the following terms:

> *"The reason we do not need that is that we are trying to compare a company's actual debt with some limit in the legislation. It is not a question of how high you can jump or how much debt a company can have; if the limit is such that it is sufficiently high to be greater than what a company has, then there is no need to do further work. So why go and value the next two or three assets in the class if you have already passed the legislation essentially? That was the thinking behind the departure there."*

However, if they have not been put through a proper revaluation process it is not possible to demonstrate that other assets in the class have not fallen in value.

Treasury's response on this issue was that:

> *"To prepare their accounts, companies have to have an idea of whether their assets are falling in value."*

That is an unconvincing argument in circumstances where companies may be seeking to derive the tax advantages of having as much gearing as possible without exceeding the threshold for thin capitalisation.

Providing for in-house revaluations with the revaluation process checked by an external independent expert will according to the evidence provide companies with significant savings in compliance costs.

That would seem to provide an acceptable trade off between reducing compliance costs and increasing compliance risks, given the requirements for the revaluation process to be properly documented.

Allowing a company to be selective about which assets in a class it will choose to revalue does not provide an acceptable trade off between reducing compliance costs and increasing compliance risks.

Recommendation

The bill should be amended to delete the provision for selective revaluation of assets in a class.

Schedule 2, Part 1

Schedule 1 will confer a number of benefits on taxpayers while Schedule 2 imposes certain compliance obligations, yet the commencement date for Schedule 2 is a year later than the commencement date of Schedule 1.

Treasury confirmed this imbalance in rights and obligations.

The Corporate Tax Association noted that the proposal to change the commencement date of Schedule 2 would be *"changing the rules after the game has finished in relation to a particular income year."*

One of the risks of legislating after the event to provide changes in tax treatment is that unless all of the compliance requirements have been adequately specified in advance there will be a risk to revenue.

Recommendation

In future the government should properly specify compliance requirements when it announces changes in tax treatment that will be legislated on a retrospective basis.

Schedule 2, Part 2

The committee considered the question of whether the proposed $2 million revenue threshold for preparing financial statements for the permanent establishment of a foreign entity would provide an avenue for tax evasion.

The Corporate Tax Association saw the threshold as not particularly relevant to big business:

> *"I see it as a small business concession. It is not something we would be banging the drum about, but we support it because it makes sense. You cannot apply the thin capitalisation rules to a foreign entity that conducts a business in Australia unless they keep records the tax office can use…The way we see it is that the sorts of assets you would be holding to generate $2 million worth of*

> *turnover would not be very big. How much can you rort the system with excessive gearing."*

Treasury gave evidence that the threshold *"has some commonality with thresholds in other areas of the tax law for similar sorts of requirements"* but did not elaborate.

Treasury's response to the specific question of whether there is a risk that foreign, high-wealth individuals could use the $2 million turnover threshold to avoid the thin capitalisation rules, was:

> *"I would not have thought so; no. This is not the type of measure that applies to individuals."*

In its submission to the committee the Institute of Chartered Accountants in Australia suggested the burden of preparing separate financial statements on small permanent establishments of overseas investors, particularly during the start-up phase of a new business venture, was inappropriate.

Recommendation

That the Australian Taxation Office monitor use of the $2 million turnover threshold to detect any pattern of abuse.

Senator Ursula Stephens
Deputy Chair

Appendix 1

Submissions Received

Submission Number	Submittor
1	Corporate Tax Association of Australia Inc
2	The Institute of Chartered Accountants In Australia
3	The Treasury
4	Australian Securitisation Forum
5	Ernst & Young
6	International Banks and Securities Association of Australia (IBSA)

TABLED DOCUMENT

Received from Institute of Chartered Accountants in Australia

ADDITIONAL INFORMATION

Received from Corporate Tax Association

Received from The Institute of Chartered Accountants in Australia

Appendix 2

Public Hearing and Witnesses

Tuesday, 29 July 2003, Canberra

Witnesses

ARMITAGE, Mr Charles Edward, Member, Tax Committee
Australian Securitisation Forum

BUCHANAN, Mr Gavin James, Chairman, Tax Sub-Committee, and
Member, National Committee, Australian Securitisation Forum

DEININGER, Ms Rosemary, Manager, Superannuation, Retirement and
Savings Division, Treasury

DRENTH, Mr Frank, Executive Director, Corporate Tax Association of Australia

GALLAGHER, Mr John Philip, Unit Manager, Business Tax Base, Treasury

JONES, Mr Robert John, Manager, International Tax and Treaties Division, Treasury

LYNCH, Mr David, Director of Policy, International Banks and
Securities Association of Australia

MANSELL, Mr Ken, Senior Taxation Consultant, Institute of Chartered Accountants

MULLINS, Mr Peter Joseph, General Manager, Business Income Division, Treasury

SALISBURY, Mr Kim, Executive Level 2, International Tax and Treaties Division, Treasury

STOLAREK, Mr Tony, Chair, Tax Technical Committee, Institute of
Chartered Accountants

TIMMERS, Mr Miquel P, Assistant Director, Corporate Tax Association of Australia