AUSTRALIAN BANKERS' ASSOCIATION INC.

ABA's response to the Tax discussion paper

1 June 2015

Australian Bankers' Association Inc. ARBN 117 262 978
(Incorporated in New South Wales). Liability of members is limited.

This page is intentionally blank.

Executive Summary

The Australian Bankers' Association (**ABA**) welcomes the Inquiry into Australia's system of taxation.

This submission discusses the elements of the current system that have served Australia well, opportunities for reform and changes that would lead to a more efficient, simpler, fairer and more internationally competitive system. A key objective is to identify changes which would reduce or remove impediments to the banking industry's access to equity and debt funding, both domestically and offshore, with a view to maximising the industry's contribution to investment, spending, economic activity and jobs.

The banking industry has identified five areas that warrant close attention by the Inquiry.

Business taxation: Australia's corporate tax rate is high relative to its international competitors. Reducing the corporate tax rate would be the single most important reform the Government could undertake. It would lower the overseas cost of capital and improve capital flows into Australia. This would produce benefits across the economy for businesses in terms of higher investment and business activity and for workers in terms of increased employment opportunities and higher wages. It would improve banks' access to foreign equity capital which again provides broader benefits across the Australian economy. Within this the ABA strongly supports the retention of current dividend imputation arrangements which keep the cost of domestic capital low and provide a valuable stream of income to domestic shareholders including household investors, superannuation funds and retirees. A lower corporate tax rate and maintenance of dividend imputation arrangements would assist banks to raise the additional capital to meet and exceed enhanced international regulatory requirements and would ensure banks' capital position remains unquestionably strong.

Housing: There is considerable scope to reduce the complexity and improve the efficiency of the taxation of housing. However, the impacts of any changes on house prices, rents, construction activity and affordability are unclear. There is a pressing need for quality empirical work on these issues and any reforms should be put aside until the consequences of reform are more certain. Any reforms should also be considered as a package across the spectrum of housing taxes.

Investment and savings: The deposit base of the banks would be broadened if there was greater equality in the taxation treatment of different forms of saving. This would also assist the demand for long-term fixed interest securities, providing a much needed boost to the development of domestic fixed interest markets and assisting the flow of funds into infrastructure investments.

Other taxes on banks: There are a number of other existing or potential taxes on banks which act as a drag on activity and increase compliance costs. These should be reviewed to improve simplicity and efficiency. The recent impetus from the Government to impose or increase levies on financial services could be viewed as "backdoor" taxation and must be justified other than on the need for additional revenue.

Simplification: The complexity and high compliance costs of the system must be addressed through a reduction in the number of taxes, harmonisation of taxes and rates across the states and territories, a reduction in the complexity of taxation law and simplification of record keeping requirements.

This page is intentionally blank.

Contents

1. Preamble 1
2. Introduction 1
3. Tax principles 4
3.1. Efficiency 4
3.2. Fairness and equity 5
3.3. Simplicity 6
3.4. International competitiveness 7
4. Business taxation 8
4.1. Company income tax 8
4.2. Dividend imputation 9
4.3. Interest withholding tax 10
4.4. Stamp duty on insurance premiums 11
4.5. Stamp duty on business transactions 11
4.6. Base erosion, profit shifting and tax reporting 11
5. Housing 12
5.1. Negative gearing 12
5.2. Capital Gains Tax discount 13
5.3. State government stamp duties 14
5.4. Land tax 15
6. Investment and savings 16
7. Superannuation 16
8. Goods and services tax 17
9. Tax simplification 19
10. Other issues 19
10.1. Funding of the Financial Claims Scheme 19
10.2. Further financial levies 20
10.3. Additional Tier 1 (AT1) and Tier 2 (T2) capital deductibility 20

This page is intentionally left blank.

1. Preamble

The Australian Bankers' Association (**ABA**) welcomes the opportunity to provide a submission in response to the Australian Government's Tax discussion paper **(discussion paper)**.

With the active participation of 24 member banks in Australia, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

2. Introduction

The role of the taxation system is to raise necessary revenue, at least cost, and in a manner which does not distort economic decision making, unless doing so is optimal for society.

To that end, a well-structured tax system can support national prosperity. Reform of the tax system should be considered as an integral part of the Australian Government's strategy to lift productivity and labour force participation, create jobs and boost economic growth.

The current system of taxation falls short of best practice in a number of areas. It is unneccesarily complicated and imposes high compliance and administration costs. It also has a narrow base with large carve outs for people, goods and services, and is not as conducive as it could be in fostering effort, innovation and investment.

The Australian taxation system is also relatively inefficient. It relies heavily on direct taxes: in 2015-16, around 47 per cent of Commonwealth cash receipts will be generated through taxes on individuals' income and another 17 per cent from company income tax. Similarly, stamp duties, the most inefficient of taxes, are the second largest source of self-generated revenue for the states and territories.

It is, in short, not as effective as it should be in driving national prosperity.

The ABA agrees that the public debate about the need for reform of Australia's taxation system is taking place in an environment of significant challenges for the economy. The economic challenges include a protracted period of sub-trend growth, rising unemployment, weak productivity growth and a long-term decline in labour force participation. These challenges are being exacerbated by the waning of the mining investment boom and steep falls in the terms of trade.

This is not to say that Australia's economic future is bleak. Quite the opposite - the ABA believes that Australia has great prospects.

An efficient and resilient banking system will play a crucial role in financing these opportunities. The banking system provides most of the funding of the Australian economy. Most of the debt funding for the banks comes from domestic deposits but this is not enough to meet all the demands on banks for financing homes, businesses and spending. The shortfall is made up through borrowings from overseas.

The banking industry is proud of the contribution it makes to facilitating investment, economic growth and jobs. Reform of the taxation system to maintain and improve the access to equity and debt funding by banks, both domestic and offshore, will ensure the industry can continue to play its part in fostering national economic success.

In this context, the ABA notes the large contribution Australia's banks make to government revenue[1]. In 2014, Australia's banks paid around $11 billion in corporate income tax - 16 per cent of total Australian Government corporate income tax. They paid another $2.5 billion in a range of other taxes to all three levels of government. Australia's banks pay a higher rate of income tax than banks in other countries in the Organisation for Economic Co-operation and Development (**OECD**) and pay among the highest average effective income tax rates of any industry in Australia.

Figure 1: Banks – Tax paid to governments ($m)

	Reporting Year 2012	Reporting Year 2013	Reporting Year 2014
Income Tax (a)	9,047	9,364	11,008
Net Unrecoverable GST	1,062	1,067	1,118
Payroll Tax	770	770	835
Policyholder Tax (Benefit)/Expense (b)	583	417	428
Fringe Benefits Tax	105	103	101
Land tax and Council rates	30	28	30
Other	100	121	143
Total	11,697	11,871	13,659

(a) Corporate income tax paid by the group to the Australian Government.
(b) Tax paid on life insurance policyholders' investment earnings

[1] Sourced from an ABA survey of member banks

Figure 2:[2] - Banks' average effective tax rate**

(Statutory corporate tax rate shown in brackets)

	2003	2004	2005	2006	2007	2008	2009	Average
Australia	25.85	30.10	29.46	30.00	29.95	23.04	31.60	28.63
	(30.00)	(30.00)	(30.00)	(30.00)	(30.00)	(30.00)	(30.00)	(30.00)
Canada	19.70	23.87	25.28	19.11	16.25	5.03	13.06	17.47
	(36.60)	(36.10)	(36.10)	(36.10)	(36.10)	(36.10)	(33.50)	(35.80)
Germany	6.27	16.71	27.26	12.39	20.39	16.41	-5.73	13.39
	(39.58)	(38.29)	(38.31)	(38.34)	(38.36)	(29.51)	(29.44)	(35.98)
Italy	17.50	20.49	20.82	21.65	23.48	4.79	12.89	17.37
	(38.25)	(37.25)	(37.25)	(37.25)	(37.25)	(31.40)	(31.40)	(35.72)
Japan	1.60	1.91	2.29	4.15	5.09	4.69	n/a	3.29
	(42)	(42)	(40.69)	(40.69)	(40.69)	(40.69)	(40.69)	(41.06)
Sweden	23.43	35.22	28.55	11.12	15.57	8.00	18.22	20.02
	(35.00)	(35.00)	(35.00)	(28.00)	(28.00)	(26.30)	(26.30)	(30.76)
Switzerland	11.62	13.67	13.49	16.24	10.66	1.06	11.67	11.20
	(25.00)	(24.10)	(21.30)	(21.30)	(20.63)	(19.20)	(18.96)	(21.50)
UK	9.15	8.23	8.99	9.50	7.91	-4.91	n/a	6.48
	(30.00)	(30.00)	(30.00)	(30.00)	(30.00)	(30.00)	(28.00)	(29.71)
USA	11.37	11.29	11.49	11.86	8.39	1.38	0.68	8.07
	(40.00)*	(40.00)	(40.00)	(40.00)	(40.00)	(40.00)	(40.00)	(40.00)

*Including federal, state and local governments

** Average effective tax rate as a percentage of net income before provisions for banks

The ABA further notes that banks pay levies to government agencies such as the Reserve Bank of Australia (for the Committed Liquidity Facility), the Australian Prudential Regulation Authority and AUSTRAC. Banks also pay a levy to the Australian Government for the use of the Government's guarantee for wholesale funding - this facility was introduced during the global financial crisis (**GFC**) but is now closed. In 2014, $533 million in levies was paid by banks to government agencies.

The review of the taxation system is one of a series of reviews that will influence the Government's policy responses to current and anticipated developments in the fiscal and economic environment. The Financial System Inquiry (**FSI**) provided a list of tax issues open for reform that are relevant to the growth of the Australian financial system. The Intergenerational Report outlined the long-term challenges of funding rising demand for government services and income support in an environment in which the number of taxpayers to support each dependent is falling. These observations illustrate the crucial role of "getting it right" on tax policy in fostering long-term prosperity for all Australians.

This submission discusses aspects of the tax system through the prism of achieving a more efficient, simpler, fairer, and more internationally competitive system, and in the context of maximising the banking industry's contribution to economic growth, employment and prosperity.

[2] Jain, Guo and Lin, (Sept 2014), *Bank Fundamentals, Executive Compensation and Public Perception of Banks in Australia*, Economic papers, Vol. 33, No. 3

Proposals for change are addressed at a high level. Further development and discussion of reform proposals is required, including modelling of the financial, economic and distributional impacts of any potential reforms.

3. Tax principles

The discussion paper identifies three principles to guide development of a better tax system.

These are:

- **Efficiency:** taxes must be collected in an economical way so as to have the lowest possible cost over and above the revenue that is raised;
- **Equity:** the distribution of the tax burden should be fair; and
- **Simplicity:** the tax system should be easy to understand and simple to comply with.

To this the ABA would add a fourth – Australia's system of taxation must be internationally competitive.

The ABA supports these principles as the foundation principles of reform of the Australian taxation system.

3.1. Efficiency

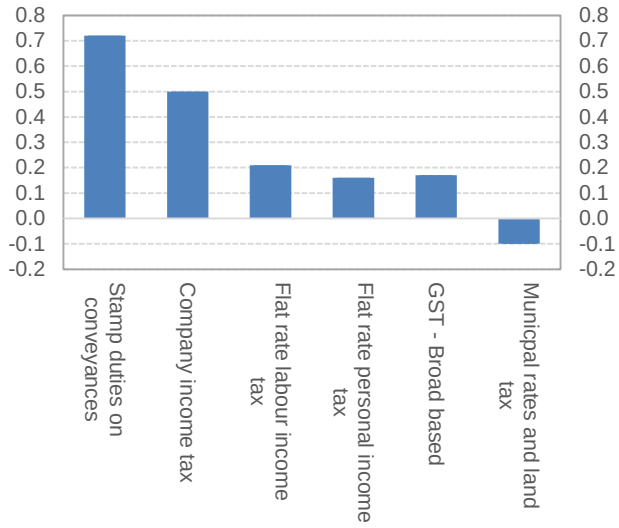
Efficient taxes have a low level of welfare loss, or excess burden, for each dollar raised by the tax. The efficiency of a tax is judged by the extent to which it distorts the behaviour of capital, labour and markets, and therefore reduces welfare. An efficient tax system should be neutral and non-distorting on behaviour, unless specifically designed to do so (e.g. pollution taxes).

From the perspective of the financial system, the allocation of funds to different sectors and the channels through which surplus funds are routed to borrowers should not be distorted by tax or other regulatory arrangements which favour one type of investment or savings over another. Financial intermediaries should be able to access all forms of domestic saving on an equal basis.

This is not the case in Australia. The Australian taxation system has a number of inefficiencies which distort saving and investment decisions. For example, interest earned on a bank deposit held directly by an individual is taxed at his or her marginal tax rate, which can be up to 50.5 per cent considering the top marginal rate, Medicare Levy, Medicare Surcharge and Budget Repair Levy. This can be contrasted to the taxation of superannuation and investment in capital assets which serves to better incentivise savings.

More broadly, as noted earlier the Australian taxation system relies heavily on inefficient taxes. Direct taxes such as personal and corporate income taxes tend to have a high excess burden by affecting incentives to work and invest, as do transaction taxes which hinder value-creating transactions that would otherwise benefit both parties. Recent Treasury modelling indicates that stamp duties have the highest excess burden of major Australian taxes, at 72 cents in the dollar, with company income tax second at 50 cents (Figure 3).

Figure 3: Marginal excess burden of major Australian taxes (for every $)



Source: Treasury (2015), Working Paper 2015-01[3]

In contrast, broad-based land and consumption taxes tend to be more efficient. Broad-based consumption taxes have limited scope for avoidance, while broad-based land taxes are on immobile capital and, when based on the unimproved land value, do not distort behaviour. Treasury modelling suggests that broad-based land tax has the least excess burden of all Australian taxes at minus 10 cents in the dollar while a broad-based GST has an excess burden of around 17 cents in the dollar.[4]

3.2. Fairness and equity

Fairness and equity calls for the tax system to treat individuals and businesses with similar capacity to pay in the same way. Fairness is important to ensuring confidence and support for the tax system.

For the corporate sector, fairness requires that taxes paid should be based on the economic value generated from operations in Australia. On this point there has been much public debate on whether some businesses, particularly large multinationals, are able to minimise the taxes paid in Australia relative to their economic presence. A tax system that ensures tax is paid in Australia when economic value is created in Australia would lead to a corporate tax system which was perceived to be fairer. This is not without difficulty, as technological change and the importance of intangibles is making it hard to determine where economic value is created. The globalisation of teams, digitisation of the economy and disagreement between countries as to what actually creates economic value (i.e. equity and intangibles vs labour) has made some basic tax principles difficult to apply.

For the banking industry the ABA observes that profits are largely retained and taxed within Australia, after which they are distributed to shareholders – mostly domestic – through dividend payouts. One driver of this outcome is the current system of dividend imputation, which is a key difference between Australia and many other countries, such as the USA, where a significantly larger share of profits is retained offshore. Likewise, the strength of the Australian controlled foreign company rules also prevents the deferral of profits in lowly taxed jurisdictions and encourages the repatriation of profits to Australia.

[3] Treasury, Cao L, Hosking A, Kouparitsas M, Mullaly, D, Rimmer X, Shi Q, Stark W, Wende S, (2015) *Understanding the Economy-Wide Efficiency and Incidence of Major Australian Taxes*, Working Paper 2015-01

[4] This was negative due to the foreign ownership of land reducing the burden of the tax on the domestic economy

Assessing fairness also requires an understanding of the incidence of a tax, i.e. who ultimately bears the burden. This is not always obvious. For example, there is a significant body of research which suggests that the burden of company income tax is born in part by workers, since it reduces real wages by reducing investment and labour productivity, and by increasing output prices.[5] An implication is that calls for higher taxes on businesses may have unintended consequences for workers.

As a general principle, reform of the tax system should seek to broaden the tax base. The burden is minimised for all if everyone contributes. The Australian system in contrast features large carve outs from the tax base. This includes various deductions from income tax for both personal and company tax payers, and also large carve outs from the GST. This has led to a progressive narrowing of the tax base with an increasing reliance on a shrinking proportion of society, which poses a challenge to the sustainability of the system.

3.3. Simplicity

A simple tax system is one that provides certainty and where the administration and compliance costs of collecting taxes are low - which minimises the regulatory burden. A tax system which is well understood by taxpayers is more likely to achieve the intended behavioural and economic responses. Simplicity also helps reduce the deadweight loss of taxation.

The Australian taxation system is very complex. It involves administration over three tiers of government; embodies differences in the application, coverage and rate of tax between governments in different jurisdictions; and incorporates complicated systems of concessions, exemptions and rebates. For most Australians it is difficult to fully comprehend.

Payroll tax is a prime example of the complexity of the system. Australia's banks include some of the biggest employers in the country, with the industry as a whole providing jobs to around 150,000 Australians across all states and territories. As noted earlier banks pay a lot - over $800 million a year - of payroll tax. While there is some rationale for varied tax rates across states - reflecting different economic characteristics and budget requirements - there are opportunities to harmonise legislation. Such harmonisation would deliver significant gains in terms of reduced administration and compliance costs.

Further departing from the ideal of simplicity, the Australian taxation system has a revenue base which is substantially narrowed through the provision of a large number of tax expenditures, i.e. special purpose concessions which reduce the tax paid. In 2014, this amounted to 297 tax expenditures across all categories of taxation.[6] The revenue forgone is tens of billions of dollars per year. These various carve outs add to complexity.

These tax expenditures have generally been granted through time to meet particular objectives and in response to lobbying from various interest groups. However, tax expenditures may not be subject to the same level of scrutiny as outlays, and it is appropriate that all tax expenditures should be reviewed against the attributes of a good tax system.

An overly complex system leads to significant uncertainty and compliance costs for all taxpayers. This is reflected in the high proportion of individuals who use a tax agent to lodge a tax return. For the 2012-13 financial year, 74 per cent of individual tax returns were lodged by a tax agent, despite the increasing use of electronic tax lodgement.[7]

---

[5] Treasury, Rimmer, Smith and Wende, (2014), *The Incidence of company tax in Australia*, Economic Roundup, Issue 1
[6] Treasury, 2015, 2014 Tax Expenditure Statement
[7] ATO, *Taxation Statistics 2012-13*, Individuals – Table 1 Selected items, for income years 1978–79 to 2012–13

3.4. International competitiveness

There are a number of aspects to ensuring Australia's taxation system is internationally competitive.

The first consideration is that Australia, as a country, has a demand for credit to fund investment and spending that exceeds its ability to source it from domestic savings. This domestic savings gap is made up by importing capital from offshore. Last financial year this savings gap - the current account deficit (**GDP**) - was a sizeable $49 billion, or over 3 per cent of GDP.

Australia's banks, as a group, have in the past relied on supplementing Australia's savings with offshore funding to meet the demands from businesses and households for finance. This reliance has been more marked for the majors. Since the GFC, this relative dependence on offshore funding has been reduced as demand for credit has slowed and as banks have boosted domestic deposit raisings.

The second consideration is the need to continue to encourage businesses to locate and invest in Australia in preference to other countries and to encourage businesses to use Australia as a base to grow and invest in international activities.

The ABA supports reform that promotes Australia as a strong and stable financial centre, encompassing a strong core of local institutions, with global scale, and a meaningful presence of foreign institutions. Branding, strategy and an internationally competitive tax system are all key pillars. This is discussed in more detail in the Financial Industry Council of Australia's ((**FICA**), of which the ABA is a member) 2009 submission to the Australian Financial Centre Forum (the Johnson Report).

Further reform of the arrangements for Offshore Banking Units would assist in this regard. The reforms outlined in the Budget 2015-16 largely give effect to the major Johnson recommendations. The ABA is supportive of the proposed reforms, but believe they could go further as outlined in the joint ABA/AFMA submission of 8 April 2015[8].

Another important consideration is the cost of Additional Tier 1 (**AT1**) and Tier 2 (**T2**) capital that banks must hold to comply with regulatory requirements introduced since the GFC and through the Third Basel Accord process. This is a global prudential initiative, yet the Australian taxation system, unlike many countries with well-established financial markets, does not treat this as debt for tax purposes, placing Australia's banks at a competitive disadvantage compared with international peers. The ABA supports legislative reform that aligns tax characterisation with prudential characterisation for entities regulated by APRA. Specifically, AT1 and T2 capital should be tax deductible to ensure that entities regulated by APRA remain internationally competitive. That would lower the cost of prudential capital for Australia's banks. There is further discussion of this issue in section 10.3.

More generally, a tax system which is competitive relative to other countries with similar development needs is a key incentive. The total tax burden includes taxes paid at all levels of government: Federal; state; and local, as well as fees and levies imposed by government authorities.

[8] Joint ABA/AFMA Submission to Treasury, (8 April 2015), *Reforms to Offshore Banking Units, Exposure Draft and Draft Explanatory Memorandum*

4. Business taxation

4.1. Company income tax

Company income tax is the second largest source of revenue for the Australian Government. In 2015-16 it is forecast to raise close to $70 billion.

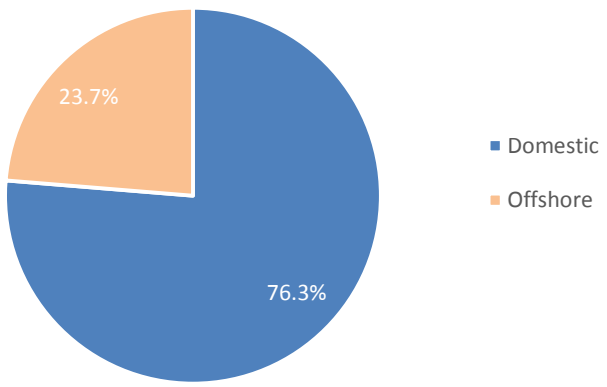
Australia currently has one of the highest company tax rates in the OECD[9] and collects a higher share of company income tax as a percentage of GDP relative to most OECD countries.[10]

The primary concern with Australia's corporate tax arrangements is that the high rate renders Australia uncompetitive in attracting international capital. Australia ultimately relies on foreign direct investment and borrowing to increase its capital stock to support economic growth and meet regulatory requirements on financial capital. The rate is less of an issue for domestic shareholders because dividend imputation means company profits are taxed at shareholders' marginal rate.

A reduction to the company tax rate would reduce the required rate of return on Australian investments, encouraging greater inflows of direct and portfolio investment into Australian companies, including banks, and providing opportunities to diversify funding sources and lower the cost of capital.

A lower cost of capital would assist banks in raising the capital required to meet and exceed regulatory requirements. This will become increasingly crucial as banks are being required to further lift capital levels to meet increasing regulatory minimum amounts. Around one quarter of bank shares of Australia's major banks are held by offshore investors and maintaining the ability of Australia's banks to be able to compete internationally for capital will remain of crucial importance.

Figure 4: Share ownership of Australia's banks[11]



[9] OECD, (2014), Tax Database. Available at: http://www.oecd.org/tax/tax-policy/tax-database.htm

[10] Parliamentary Budget Office, (2014), *Trends in Australian Government receipts*. Available at: http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Budget_Office/reports/Trends_in_Australian_Government_receipts

[11] ABA data compiled from information published by the main retail banks

More broadly, the discussion paper notes that the economic burden of company tax is ultimately shared among its shareholders, consumers and employers, and that, in the long run, over half of the economic burden is likely to be shifted to workers through lower real wages. The ABA notes a similar conclusion in a 2014 paper by three researchers at the Australian Treasury[12]:

> *"Company taxes reduce real wages, including by increasing production costs and the price of final goods, so that a substantial share of the welfare costs of company taxes are borne by labour.*
>
> *"In the near term a decrease in the company tax rate would increase the after tax rate of return on capital. The higher rate of return results in higher investment and, over time, a larger capital stock. The increased stock of capital means that labour is more productive and real wages are higher.*
>
> *"The overall size of the economy increases due to increases in both the capital stock and the labour supply."*

The conclusion is that the single reform most beneficial to the economy would be a cut in the company tax rate.[13] This would produce benefits across the economy for businesses in terms of higher investment and business activity and for workers in terms of increased employment opportunities and higher wages. It would improve banks' access to foreign equity capital. Offsetting a company tax cut through increases in other taxes to maintain budget neutrality should still achieve net economic benefits.

4.2. Dividend imputation

Dividend imputation allows Australian-based companies to attach an imputation credit to dividends and certain other distributions paid to shareholders. Taxpayers can use this credit to reduce their personal income tax liability for the company tax already paid. Individuals that do not pay income tax or pay tax at a rate below the company tax rate (such as retirees or superannuation funds) may receive a refund for company tax paid.

The ABA believes dividend imputation has served Australia well and strongly supports the existing dividend imputation arrangements.

Imputation removes the double taxation of profits i.e. double taxation being the application of tax to both company profits and the dividend receipts in the hands of shareholders. Imputation also provides for neutral treatment between incorporated and unincorporated entities. This supports the integrity of the tax system and encourages businesses to not undertake elaborate avoidance activity.

Dividend imputation increases the after-tax returns to investment in domestic equities and is a desirable incentive to promote domestic savings. A larger pool of domestic savings reduces the dependence of Australian corporates, including banks, on external sources of capital which can be more volatile, and facilitates raising the capital to ensure banks remain unquestionably strong. A larger pool of domestic savings also supports the robustness of Australian corporates during downturns and periods of market volatility. It also reduces leverage for non-financial corporates, which dampens the potential to shift capital abroad when local returns fall relative to foreign markets.

Dividend imputation also supports shareholder income, largely through superannuation accounts, including self-managed superannuation funds and industry funds, and therefore retirement incomes.[14] As noted, the shareholder base for banks is largely domestic, at around three quarters across the four major listed banking corporations.

---

[12] Treasury, Rimmer, Smith and Wende, (2014), *The Incidence of company tax in Australia*, Economic Roundup, Issue 1

[13] *Ibid*

[14] As observed, for example, with changes to dividend taxation in the UK; see Bell and Jenkinson, 2000, *New evidence of the impact of dividend taxation and on the identity of the marginal investor,* University of Oxford Economics Department of Economics Discussion Paper

The ABA believes the imputation system would be improved through a Trans-Tasman mutual recognition (**TTMR**) of imputation credits between Australia and New Zealand. Some of Australia's banks have considerable New Zealand based banking operations. TTMR would remove the double taxation of cross-country equity flows between the two countries, reducing the cost of capital for affected banks and improving the mobility of capital. It is also consistent with the principle of maintaining Closer Economic Relations between the two countries. Economic modelling undertaken on a potential TTMR suggests that it would increase net trans-Tasman GDP by NZ$5.3b by 2030 (present value terms), at an annual fiscal cost in the range of NZ$111 million to NZ$750 million for Australia, and NZ$135 million to NZ$220 million for New Zealand[15].

TTMR is consistent with dividend imputation and is consistent with the provision of foreign tax credits to cross-border non-corporate direct investment. If Australia and New Zealand were operating a cooperative imputation system, TTMR would be the standard from both an equity and efficiency standpoint. Mutual recognition is appropriate as Australia and New Zealand are the only two countries which have imputation.

The relevant focus is the economic benefits of TTMR, being the avoided economic costs of the taxes relieved by TTMR. The economic benefits of TTMR are the avoidance of distortions to trans-Tasman equity investments made by Australian and New Zealand investors. TTMR would reduce tax induced differences between relative rates of equity returns to investments in New Zealand versus investments in Australia. Modelling done by the Joint Australian and New Zealand Productivity Commissions confirm this.

4.3. Interest withholding tax

Interest withholding tax (**IWT**) applies at the rate of 10 per cent on the gross amount of interest paid by Australian borrowers to non-resident lenders.

The main exemptions are for institutions which raise debt through the public offer of debentures to non-residents, for foreign superannuation funds and exemptions in various tax treaties. There are no exemptions for deposits raised by Australia's banks from offshore customers.

In theory, withholding taxes have the advantage of ensuring that tax is paid in Australia, rather than overseas, without imposing any additional cost on the payer.

However, the limitations of current exemptions have resulted in significant competitive distortions and inconsistencies.

Foreign lenders do not generally absorb Australian IWT. As a result, the IWT increases the cost of funds to Australian borrowers as they are required to gross-up the interest payments so as to effectively bear the burden of the IWT themselves.

This places prohibitive costs on Australian borrowers to access sources of funding on which the IWT applies, narrowing the sources and increasing the cost of funding available to Australia's banks. This is detrimental to Australia's financial and economic health given our position as a net capital importer.

As highlighted in both the Henry Review and Johnson Report,[16] a relatively revenue-neutral response could be to introduce exemptions on interest paid to non-residents for funding the operations of banks in Australia, either to:

- apply to all interest received by all non-residents from the Australian operations of banks; or

[15] Based on a range of studies conducted separately by the Australian Productivity Commission, the New Zealand Institute of Economic Research (NZIER) and the Centre for International Economics (CIE), and the New Zealand Inland Revenue Department

[16] Report by the Australian Financial Centre Forum, (November 2009) *Australia as a Financial Centre: Building on our Strengths*, pp 65-68

- apply to all foreign wholesale funding of Australia's banks.

The ABA believes there would not be a significant cost to revenue from these changes as banks are simply not accessing these valuable sources of funding under current arrangements.

4.4. Stamp duty on insurance premiums

All states impose duties on general insurance premiums, although there are a number of exemptions and concessions.

Insurance taxes can lead to under-insurance. They are one of the least efficient taxes and, in the presence of market failures that naturally result in under insurance and non-insurance, exacerbate the problem by providing an additional barrier to the taking out of insurance.

Reductions in the size of the insurance market also reduce pooling opportunities, which will also tend to increase premiums.

While stamp duties on insurance are generally simple and easy to administer, the under-insurance generated by their presence may outweigh any benefits arising from their simplicity, particularly where government expenditure occurs to support under-insured communities in adverse events.

Removal of stamp duties on insurance would be expected to reduce the level of under-insurance and promote appropriate protection against risk in the community. Ultimately, this would be likely to reduce the level of government support required when under-insured populations experience disasters.

4.5. Stamp duty on business transactions

State and territory governments also apply stamp duty to the sale of businesses.

This tax lowers the volume of transactions with the result that some beneficial business transactions do not occur.

The application of stamp duty to the full sale price of a business also acts as a barrier to business investment.

Removal of stamp duty on business transactions would simplify taxation arrangements, and potentially increase the level of mutually beneficial business sales.

4.6. Base erosion, profit shifting and tax reporting

The ABA has already observed there is a view that some businesses, particularly large multinationals, are able to minimise the taxes paid in Australia relative to their perceived economic presence.

The ABA has also already observed that the banking industry paid over $13.6 billion in tax in 2014 and that the industry has little incentive to minimise its taxation bill relative to its economic presence in Australia as profits are largely retained in Australia and distributed to shareholders, mostly domestic, through dividend payouts. Overall, the flow of financial benefits to the economy from banks' operations in Australia is very high.

The ABA supports in principle the Government's initiatives to reduce the leakage of tax revenue by addressing the ability of non-Australian companies to arbitrage international tax regimes so as to minimise taxable income booked in Australia, including the new tax integrity measures announced in the 2015-16 Budget on 12 May 2015. Further discussion on the detail of these measures would be welcome to ensure they are targeted and do not have unintended consequences. (This is limited, or not possible, for Australian multinationals given the operation of Australia's Controlled Foreign Company regime). The ABA also encourages the Government's continued participation in the broader G20/OECD initiatives on

BEPS, but would caution against unilateral action that may create a competitive disadvantage for Australian multinational companies relative to companies from other OECD/G20 countries.

The ABA also supports the measures to increase transparency of income and tax flows through the G20 Common Reporting Standard (**CRS**) implementation plan and greater cooperation and collaboration by tax authorities in tax compliance matters. However, it is important to ensure that the process for complying with these important transparency requirements is streamlined as much as possible to remove duplication and unnecessary compliance cost. Closer alignment of the CRS to the Foreign Account Tax Compliance Act (**FATCA**) would assist in this regard.

There can be little argument that companies should pay tax in the country where the real economic activity occurs and where the profit is earned.

It is difficult to estimate how much additional domestic revenue these actions will generate and how quickly this will be delivered. Nevertheless, revenue booked from these measures will improve the integrity of the domestic tax regime and should be utilised to fund a reduction in the corporate tax rate.

5. Housing

Taxation of the housing sector in Australia does not meet the principles of good taxation. It is complex with many different taxes, rates and carve outs and relies heavily on inefficient taxes.

This section addresses four taxes that have substantial effects on housing investment: negative gearing; Capital Gains Tax (**CGT**) discount; stamp duties; and land tax.

5.1. Negative gearing

Negative gearing allows individuals who incur a net loss from their investment to deduct the loss from their total personal income tax liability so that losses from an investment can be offset against other income. A taxpayer is able to claim a deduction for expenses incurred from borrowing money that is used for the purpose of producing assessable income. This provides an effective tax reduction for negatively geared assets.

In 2012-13, over 1.2 million Australians owned a negatively geared property,[17] with deductible losses of more than $12 billion. Nearly 800,000 negative gearers had a gross income of less than $80,000[18], however the RBA has estimated that households with disposable incomes in the top 20 per cent of the income distribution owe most of investor housing debt (around 60 per cent) and a significant portion of total housing debt (28 per cent).[19]

Loans secured by residential property make up a substantial portion of Australia's banks' asset book with total housing outstandings of $1,337 billion within a total asset book of $2,372 billion (excluding lending between financial institutions) as at March 2015. Investor loans outstanding are $469 billion, a bit over a third of the housing book.[20]

The ABA agrees with the observation in the discussion paper that the tax advantage for individuals investing in property does not come from borrowing. Rather, the potential tax advantage comes from the taxation of the capital gain earned from the asset.

[17] Australian Taxation Statistics 2012-13, Table 9, Individual selected items by taxable incomes and total incomes
[18] *Ibid*
[19] Reserve Bank of Australia, (September 2014), *Financial Stability Review*: Box C
[20] Reserve Bank of Australia, Table D5; http://www.rba.gov.au/statistics/tables/

The ABA also notes the conclusions in a recent report commissioned by the Housing Industry Association[21] that discounting residential negative gearing would lower Australian living standards by making the tax system less efficient, but that reducing the overall tax burden on the housing market is likely to have important benefits for both housing affordability and living standards.

In addition, the ABA acknowledges the commentary in the recent Economics References Committee report into housing affordability[22], that Treasury is unable to quantify the impact of negative gearing on the supply of houses, prices, rents and housing affordability. It supports the recommendation of the Committee (recommendation 9.70) that Treasury should prepare and publish a study on the influence of negative gearing on the housing market.

Public policy making would be assisted by greater transparency and certainty on these issues and it is prudent to exercise caution on any changes to this area of taxation until the facts are settled.

The recently convened House of Representatives Economics Committee Inquiry into Home Ownership will provide a useful forum for these issues to be explored more fully.

5.2. Capital Gains Tax discount

The CGT discount allows a resident individual or trusts to pay tax on only 50 per cent of any nominal capital gain that is realised when an investment that is sold has been owned for at least 12 months. This gain is taxed at the individual's marginal tax rate. Domestic superannuation funds only pay tax on two thirds of nominal capital gain in the accumulation phase.

A rationale for the CGT discount is that it compensates investors for the effect of inflation on capital gains and the double taxation of savings. The discount also reduces the tax on disposal of the asset and reduces the incentive to hold on to assets to avoid realising the profit and paying the tax. This reduces the immobility of the capital stock, so that capital can flow to where it is most productive, and encourages risk taking and entrepreneurialism through longer term investment.

Other assets, such as bank deposits, do not always receive equivalent concessions. Further, income on savings incurs annual taxes, while capital gains taxes are deferred until sale of the investment. Such inconsistencies may result in misallocation of national savings.

The ABA supports the retention of the current CGT discount arrangements, but observes that some form of equalisation is desirable to ensure that household investment choices are more closely aligned with individual circumstances and risk preferences. Extending comparable concessions to other forms of savings, such as bank deposits, could be a means of achieving this goal. In practice this might mean applying a concessionary tax rate to income earned on fixed income products or cash deposits.

Conceptually, extending concessions to other forms of saving would lead to more equal marginal tax rates on income from investment in real assets and from financial assets such as bank deposits. All else being equal, it would reduce or remove distortions which direct investment to particular asset classes. The impact on asset markets is not clear.

Changes to these arrangements would need to be assessed as part of a package of reforms including other housing tax policies. Assessment of these issues requires further development and discussion, including modelling of the financial, economic and distributional impacts.

[21] Independent Economics, (1 June 2014), *Economic Impacts of Negative Gearing of Residential Property*, report prepared for the Housing Industry Association

[22] The Senate Economics References Committee, (May 2015), *Out of reach? The Australian housing affordability challenge*

5.3. State government stamp duties

State and territory governments levy stamp duties on the purchaser of land or buildings. The duty is based on the reported sale price and is charged at a progressive rate. The states and territories charge different rates of stamp duty and apply different thresholds and exemptions.

In 2013-14, stamp duties contributed almost $16 billion to aggregate state and territory revenues and were the second largest source of revenue that states and territories generated themselves[23].

Stamp duty is a highly inefficient tax. As noted earlier, a recent Treasury analysis found that stamp duty had the highest excess burden of any of the taxes analysed, with a burden of 72 cents for every dollar of revenue raised.[24]

Stamp duty reduces turnover in the stock of housing, so that sales and purchases that would otherwise be beneficial to both parties are lower than they would otherwise be. In terms of the sensitivity of turnover to taxes, one study estimated that an increase in stamp duty of 10 per cent would lower property transaction volumes by up to 6 per cent in the long term.[25]

The reduced turnover of the housing stock resulting from stamp duty is reflected in poor allocation of housing stock. Older homeowners who no longer need a large home are discouraged from downsizing. This in turn makes it harder for people to find housing that meets their needs and creates incentives to renovate and add to existing housing.

Stamp duty on housing transactions also acts as a barrier to labour force mobility, by acting as a tax on moving in response to changing employment opportunities. It also presents equity issues by placing a larger tax burden on those who move. Those who do not move are not subject to the tax.

Finally, stamp duty acts as a barrier to entry for new homeowners, with the stamp duty requirement reducing the size of the available deposit.

From the perspective of the states and territories, stamp duty is a highly variable revenue stream that shifts with transaction volume and property prices, leading to large fluctuations in income.

The economic cost of stamp duty can be reduced or removed through a reduction in the rate of duty or its complete abolition.

Removal of stamp duty on housing transactions would simplify taxation arrangements. It would improve efficiency by increasing the level of beneficial transactions and by improving the allocation of resources. It would also result in a substantial decrease in the excess burden of taxation. It would lead to a more efficient allocation of housing, as it would no longer act as a barrier to downsizing or moving to a more suitable property. It would also cease to act as a barrier to workers seeking to move for better employment opportunities.

The abolition of stamp duty would be expected to result in an increase in property values, particularly in an environment of constrained supply. For banks this would improve (reduce) the loan to valuation ratios (**LVR**) of existing borrowers, with a concomitant reduction in the riskiness of the existing housing book. It would lift the effective available deposits for new borrowers, although the effect of this on improved housing affordability may be offset by higher purchase prices.

As an interim measure, the ABA notes that a harmonisation of stamp duty rates and arrangements across the states and territories would substantially reduce complexity and would lead to a reduction in compliance and administration costs for nationally operating institutions.

---

[23] ABS, Taxation Revenue, 2013-14, Cat No. 5506.0

[24] Treasury, Cao L, Hosking A, Kouparitsas M, Mullaly, D, Rimmer X, Shi Q, Stark W, Wende S, (2015) *Understanding the Economy-Wide Efficiency and Incidence of Major Australian Taxes*, Working Paper 2015-01

[25] Davidoff, I and Leigh, A, (2013), *How Do Stamp Duties Affect the Housing Market*? IZA Discussion Paper No. 7463

5.4. Land tax

Land taxes are levied by state and territory governments on the unimproved value of land. They are applied through a progressive scale based on an entity's total land holdings (except the ACT, where it is based on value per property). The Northern Territory does not levy land taxes.

Existing land taxes are narrowly applied. They are levied on commercial land and investor-owned residential land, but with exemptions. While exemptions vary by jurisdiction, they tend to include: owner-occupied residential land; primary production land; land for child care and aged-care facilities; land owned by not-for-profit and charitable organisations; leasehold land; and government-owned land.

Land tax is a more efficient form of property tax than stamp duty, particularly when it is broad-based. However, the current arrangements effectively exclude around 70 per cent of land through owner-occupier and primary production exemptions. Land can shift in and out of the tax base as ownership changes, which is itself a source of complexity and can distort economic decisions.

To illustrate the problem, rental property owners need to recoup land tax through higher rents, so renters bear the burden, whereas owner occupiers do not "pay" a land tax in the imputed housing services they receive from ownership. This has implications for equity.

Further, housing investment will tend to be directed toward properties where land is a low proportion of total value, such as apartments.

Also, with land tax levied on a progressive scale, it distorts investor behaviour, discouraging large-scale investments. This may lead to a fragmentation of the housing investment market and lead to its dominance by small-scale investors.

Taken together, the current arrangements are complex and produce less efficient and equitable outcomes than otherwise.

Conceptually, the ABA acknowledges that broadening the land tax base by reducing the large number of exemptions and adjusting land tax rates would improve the efficiency of the taxation system but cautions that this should only be considered as a package of reforms including the reduction or removal of stamp duties.

The ABA further cautions there are risks if such reforms were introduced too quickly. For example, a change in arrangements over a short timeframe will result in those who recently paid stamp duty being hit with another tax obligation. Also, extending land tax to existing home owners could potentially hurt cash flows and may impact on the financial viability of recent borrowers. It would also likely reduce home prices, increasing LVR, which again could be an issue for recent borrowers. Any tax changes which increase the financial vulnerability of borrowers would be of concern to banks.

Extending land tax to the place of primary residence may also affect asset-rich but income-poor landowners, such as retirees. Arrangements such as enabling the capitalisation of land tax obligations against the sale of the property would potentially be required.

Such a package of reforms would require well-structured transitional arrangements. The ABA notes the reforms underway in the ACT, with transaction taxes being phased out over a period of 5 to 20 years and general rates adopted as a broad and efficient revenue replacement base, with improved progressivity.

Time will provide further insights into the success of these tax reforms and optimum transitional arrangements.

6. Investment and savings

Differences in the tax treatment of income derived from different types of savings instruments changes their relative risk adjusted returns without necessarily changing the overall incentive to save. This can distort the allocation, ownership and management of capital, leading to a misallocation of resources and lower productivity.

The current system taxes some savings at the individual's full marginal rate (bank accounts and debt instruments) while others are taxed at a highly concessional rate (investment in physical assets and superannuation). This creates a tax bias against deriving income from bank deposits and debt instruments, which may have contributed to the need for banks to go to overseas capital markets to make up for a domestic funding shortfall.

This bias against interest earning instruments also makes long-term fixed interest investments less attractive to superannuation funds and retirees and may restrict the supply of funds for stable investment in long-term infrastructure projects.

The current differentiated tax treatment of savings can be addressed through the introduction of additional measures to provide tax relief to investments that are less attractive under existing arrangements (e.g. by providing a form of "tax-preferred account" with a lower tax rate on interest income).

Such measures would make bank deposits and debt instruments more attractive relative to what are currently tax advantaged alternatives. This would facilitate greater domestic fund raising by banks. It would also assist the development of private domestic long-term fixed interest markets.

7. Superannuation

An efficient and resilient superannuation system is crucial given its task in funding the economy and delivering retirement incomes.

At the end of 2014 total superannuation assets were $1.93 trillion, around 121 per cent of GDP, with growth likely to continue for some time before slowing as the number of superannuants in the retirement phase starts to outweigh those in the accumulation phase.

Australia's superannuation system has a number of social and economic benefits:

- Superannuation enhances retirement incomes and maintains living standards.
- It reduces reliance on the Age Pension, helping Australia to meet the fiscal challenges of an ageing population.
- By increasing national savings, superannuation plays an important role in providing long-term funding for economic activity in Australia, both directly through the investment decisions of superannuation funds, and indirectly as invested funds are placed with financial institutions. The large pool of superannuation savings contributed to the stability of Australia's financial system and the economy during the GFC.

There are strong links between superannuation and Australia's banks:

- Banks offer a range of superannuation products to the public.
- Superannuation funds allocate 47 per cent of their assets to financial entities in the form of investments in shares, securities and deposits, with 15 per cent held as deposits.

The arrangements under which superannuation receives concessional tax treatment in both the accumulation and drawdown phases is compensation for deferring consumption and reflects its contribution to reducing the call on government resources to support retirement incomes.

Much of the debate about changing the taxation arrangements for superannuation has been centred around improving fairness and reducing the tax concessions available to higher income earners.

However, there is not a consensus on the cost of superannuation concessions to the Federal Budget. Further work on determining the true cost of current arrangements and of the savings to be generated through changes would assist the public assessment of the current system and of the need for reform.

While it is often argued that higher income earners are able to take more advantage of existing tax concession arrangements, the ABA notes that access to the Age Pension for lower income earners works to equalise contributions to lifetime retirement income.

The Australian superannuation system is highly regarded internationally, both in terms of the contribution to national savings and reduced dependence on the government budget, and in terms of facilitating the development of a world class funds management industry in Australia.

The ABA fully supports seeking political consensus on the objectives of the superannuation and retirement income system. The ABA also believes that the superannuation and retirement income system should reflect the guiding principles of simplicity, flexibility, adequacy of saving, literacy, stability and certainty, and transparency.

8. Goods and services tax

For banks the objective of a review of the GST arrangements should be to achieve more efficient and simpler tax arrangements with a view to minimising the overall tax burden for customers.

Typical of most GST and Value Added Tax (**VAT**) systems, the Australian GST "input taxes" certain financial services, particularly those where it is difficult to identify and measure the value added. By "input taxing" financial services, no GST is payable on the supply of the financial service, however, the bank is not entitled to claim a credit for any GST it pays on the costs associated with providing those services.

"Input taxing" financial services means that GST becomes a direct cost to financial institutions. The annual net GST cost to financial institutions is in excess of $1.1 billion. Consequently, to the extent these costs are passed onto customers, an increase in the GST rate under current arrangements will lead to an increase in the cost of providing financial services to the community.

Uniquely, Australia's GST is designed to limit the circumstances in which financial services are input taxed to restrict the number of taxpayers potentially affected. This is achieved by imposing GST on many "intermediary" services (for example, external providers such as the services of mortgage brokers, fund managers and arrangers of financial transactions) that would be input taxed in other GST and VAT regimes.

In order to lower the cost of taxable "intermediary" services, the GST charged on these services is partially set off by a credit known as a reduced input tax credit (**RITC**). The RITC ensures that GST is not a factor in a financial institution deciding whether or not to outsource to external providers.

In this regard, we note the following:

- The Australian GST system strikes the right balance between those financial services that are input taxed and those financial services where GST is imposed. This approach, supported by the RITC regime, maximises the Government's GST revenue collections from financial services and minimises (to the extent possible) the effect of unrecoverable GST. Minimising the cost of GST reduces the amount of GST flowing through to customers in the price of financial services they acquire.

- When compared to many other GST and VAT regimes, the existing RITC regime reduces the incentive for financial institutions to "insource" business inputs. Maintaining the existing RITC regime (including existing rates) ensures that the cost of providing financial services is lower than under comparative GST and VAT systems.
- Some countries have studied the feasibility of fully taxing financial services for GST or VAT purposes. However, to date no successful model has been developed and no country has fully taxed financial services. Some countries have considered applying a zero rate (GST-free rate) to financial services, which inevitably comes with a significant cost to revenue. That said, even a zero rate regime raises significant issues of demarcation, particularly in relation to which services should be taxable and which zero-rated.

The ABA does not support the introduction of further "transaction taxes" on financial services.

9. Tax simplification

The ABA agrees that the current tax system is characterised by high complexity and high compliance costs. There are four broad avenues for policy to address these issues:

- Reduce the number of taxes to which entities are subject. The ABA has already noted that banks are subject to: income tax; unrecoverable GST; insurance policyholder tax; payroll tax; fringe benefits tax; land tax and council rates; other taxes such as stamp duty; and a number of levies to government regulatory authorities. The multiple taxing points impose high compliance and administration costs.
- Harmonise taxes across states, in terms of the tax base, definitions, and exemptions. Uniform arrangements across the states and territories would minimise compliance costs for multi-state businesses, enhancing the flexibility of labour and capital markets, and work to further attract foreign investment.
- Reduce complexity in current tax law to reduce the compliance burden and improve certainty. This would reduce the regulatory burden for taxpayers and would reduce the resources devoted by the ATO to resolution of disputes. It would also improve the attraction of Australia as a place to do business, particularly against competing centres in the region where tax regulation is less of a burden.
- Simplify the record keeping requirements and regulatory burden on taxes where it is disproportionate to the revenue raised. FBT is an example where significant simplification could be achieved, reducing the cost of compliance to all Australian employers.

10. Other issues

This section focuses on other tax issues of specific relevance to the banking industry, in particular those taxes that distort the allocation of funding and risk in the economy.

10.1. Funding of the Financial Claims Scheme

In August 2013 the former government announced that a levy, equal to 5 basis points, would be applied to all deposits covered by the Financial Claims Scheme (**FCS**).[26] This was the key element in a move to fund the FCS on an ex-ante basis rather than on the ex-post basis, which had been the case up to that point. The proceeds of this levy were to be invested in a dedicated Financial Stability Fund.

At the time the ABA objected on the grounds that the levy was a tax on depositors and was unnecessary given the other protections in place for depositors.

[26] Economic Statement, (August 2013), statement by the Hon Chris Bowen MP and Senator the Hon. Penny Wong, Canberra

The Final Report of the FSI recommends the ex-ante funding of the FCS should be abandoned and that the FCS should revert to an ex-post funding structure (Recommendation 6).

The Government is yet to announce its response to this recommendation, which has created uncertainty for the banking industry and for depositors. While the proposal to adopt ex-ante funding would have imposed an ongoing tax on depositors of all Authorised Deposit-taking Institutions (**ADI**), the ex-post funding structure provides that in the very unlikely event of a failure of an ADI, the Government would provide the necessary funds to protect deposits and then reclaim them from liquidating the institution. The levy for the "insurance" provided by the Government is paid only if the FCS is activated and there are insufficient funds recovered through liquidation to recover the costs.

While the precise size of the levy is not clear, a simple calculation suggests it would be in the order of $361 million per year from the 5 basis points levy on eligible FCS assets of $723 billion. This is a sizeable impost.

The ABA supports the FSI's recommendation to abandon ex-ante funding.

10.2. Further financial levies

Banks already pay $500 million a year in fees and levies to regulators such as APRA and the RBA.

The ABA notes FSI Recommendation 29 to introduce an industry funding model for the Australian Securities and Investments Commission.

In its response to this recommendation the ABA commented that it is essential that any adoption of the user pays principle or cost recovery by ASIC be accompanied by appropriate checks that industry contributions are utilised efficiently, and that there are limits on the size of levies to ensure they are reasonable and consistent with the services provided.

The ABA also noted that an appropriate governance framework is required. Government needs to be mindful that industry-based funding for public entities is a form of taxation. Further information on the ABA's views on this matter can be found on pages 24 and 25 of the ABA response to the Financial System Inquiry[27].

10.3. Additional Tier 1 (AT1) and Tier 2 (T2) capital deductibility

As a consequence of the GFC and through the Third Basel Accord process, international banking regulators have significantly increased the minimum level and composition of capital that banks are required to hold as a buffer against risk. The types of regulatory capital that APRA requires to be regulated includes AT1, T2 and Common Equity Tier 1 capital.

The Australian taxation system has not kept pace with this change. The current debt/equity rules contained in Division 974 of the *Income Tax Assessment Act 1997* treat AT1 capital instruments issued by Australia's banks as equity interests for tax purposes and as a result no tax relief arises for distributions on these instruments. Many other countries with well-established financial markets, on the other hand, have introduced specific rules to ensure that AT1 and T2 capital is treated as debt for tax purposes.

[27] ABA's response to the FSI Final Report: p24 and 25, http://www.bankers.asn.au/FSI/ABA-submissions/ABA-submissions

Accordingly, the existing tax arrangements place an additional cost on Australia's banks (and other entities regulated by APRA), placing them at a competitive disadvantage compared with non-regulated corporates that can raise capital outside of the prudential standards, and international banks in jurisdictions where capital raising costs are treated as tax deductible.

The ABA strongly supports that Division 974 be amended to make clear that AT1 and T2 capital be treated as debt for income tax purposes. This would move Australia in line with international standards and lower the cost of prudential capital for Australia's banks.

As a reference point, in the UK, Statutory Instrument 2013 No.3209 and Her Majesty's Revenue and Customers (HMRC): *The Taxation of Regulatory Capital Securities 2013* have the effect that distributions on certain qualifying AT1 instruments (i.e. legal form debt) issued by UK incorporated banks will be deductible for UK tax purposes. The ABA views this legislation as an appropriate model to adopt.