31 January 2014

Mr Stephen Hally-Burton
Budget Policy Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Via Email prebudgetsubs@treasury.gov.au

Dear Mr Hally-Burton

2014-15 Pre-Budget Submission

The Australian Financial Markets Association (AFMA) represents the interests of over 130 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

In making its submission with respect to the 2014-15 Federal Budget, AFMA is mindful of the continued fiscal challenges presented by the current global economic climate and the stated policy objectives announced by the Government with respect to returning the Budget to surplus in a foreseeable timeframe. Accordingly, the issues raised in our submission are those that AFMA believes will stimulate economic activity of Australian enterprises and hence be revenue accretive over the short to medium term.

AFMA also acknowledges that the 2014-15 Federal Budget will be handed down in the midst of the Financial System Inquiry and in advance of the commencement of the Tax Reform White Paper process. Both of these inquiries will provide an opportunity for perspectives to be put to Government that will be directly relevant both to AFMA and its membership. Accordingly, the substance of AFMA's 2014-15 Pre-Budget Submission focusses on those matters that are considered urgent or otherwise fall outside the Terms of Reference for either inquiry.

More generally, AFMA would urge the Government to use the 2014-15 Budget to provide a cohesive policy framework, articulating clear principles that it will use to drive the legislative agenda into the medium term. An example that is close to the heart of many AFMA members is the Government's seemingly piecemeal approach to the recommendations of the report by the Australian Financial Centre Forum (**AFCF**) entitled "Australia as a Financial Centre: Building on our Strengths" (the **Johnson Report**). There

have been a number of public statements from Government ministers that have given rise to an inference that the Government was supportive of the recommendations of the Johnson Report. However, as evidenced by the Government's announcement to discontinue the phase-down of interest withholding tax for financial institutions, starkly in contrast to the recommendation of the Johnson Report, it is clear the Government does not endorse, and will not pursue, all of the Johnson recommendations. A transparent articulation of policy principles by the Government is necessary to drive confidence from both an investor and also from a business perspective.

As will become increasingly apparent through the Financial System Inquiry, financial markets and particularly debt securities markets (such as corporate bond markets) are becoming systemically more important. Banks will be increasingly constrained in their capacity to leverage their balance sheets to comply with enhanced regulatory capital and liquidity requirements. Accordingly, it is our view that Treasury policy generally, and the 2014-15 Budget specifically, should reflect the current economic and financial climate and ensure that reforms that are undertaken promote the efficiency and competitiveness of the Australian financial markets. In particular, this means regulatory and other changes mandated through the G-20 or otherwise should be approached from a holistic perspective, adopting a "whole of regulation" mantra. That is, to the extent that changes are required to the taxation system to ensure consistency with regulatory reforms, these be implemented consistently and not only where there is a perception that the amendments will be revenue accretive for the Government.

AFMA further believes the merits and rationale of a particular measure should be considered autonomously as opposed to being rejected merely due to a perception as to how it is being funded. The linkage of specific revenue items to specific expenditure items is inherently dangerous, as it makes the implementation of laudable policy objectives contingent on the success of the linked measure. A more appropriate way to assess whether to proceed with the particular tax measure is to understand its effects in the overall budgetary context, both immediate and beyond the forward estimates period. A prime example is the Government's announcement to discontinue the phase-down of interest withholding tax purely based on its purported linkage to the Minerals Resource Rent Tax, as opposed to an assessment of the benefits such a phase-down would deliver to banking competition and the needs of the real economy.

In a similar vein, AFMA also urges the Government to consider policy settings and impacts of reform beyond the forward estimates period. We continue to advocate measures that will, in time, promote banking competition, ensure the ongoing viability and indeed improve our financial services industry and increase the efficiency of capital moving in and out of Australia. While the implications of such measures may not be revenue accretive (or indeed may be unquantifiable) over the forward estimates period, in AFMA's view they will deliver real benefits over a reasonable time-frame and are crucial to ensure that the financial system has the necessary grounding to continue to service the real economy in an optimal manner.

Tax Administration

In addition to specific measures, AFMA recommends that the Government continue to focus its attention to issues of tax administration. AFMA welcomed the announcement

by the Government on 6 November 2013 that it would undertake measures to reduce uncertainty for business by tackling the backlog of announced but unlegislated tax measures. Indeed, AFMA's 2013-14 Pre-Budget Submission strongly suggested that this backlog be attended to as a matter of urgency.

One measure that was announced in the 2013-14 Budget was the establishment of a Tax System Advisory Board within the Australian Taxation Office (**ATO**) to "advise the Commissioner of Taxation and the ATO Executive Committee on the strategic direction, culture, organisation, management, compliance planning, staff profile and information technology plans at the ATO." AFMA welcomed this announcement and believes that an additional body providing independent oversight and stewardship over the ATO makes sense. We would urge the Government to progress a similar initiative in this area.

More broadly, the cessation of the Business Tax Working Group means that there is no independent body dedicated to considering the tax reform process and the continued refinement of Australia's taxation system. Whether this is an issue for the 2014-15 Budget or the Tax Reform White Paper, the Government needs to consider how it will ensure the competitiveness of Australia's taxation system is ongoing and enduring.

* * * * *

Thank you for the opportunity to contribute to the Government's consideration of matters that should be addressed in the 2014-15 Budget. We would be happy to discuss any of the matters that we have raised in this submission.

Yours sincerely,

Rob Colquhoun
Director, Policy (Taxation)

1. Discontinuance of Phase-Down of Interest Withholding Tax

AFMA would like to again take the opportunity to express significant concern about the announcement by the Government of the discontinuance of the previously announced phase-down of interest withholding tax for financial institutions. This announcement was formally made by the Government as part of the repeal of the Minerals Resource Rent Tax.

In the Johnson Report, the AFCF expressed the view that "the application of interest withholding tax to offshore borrowings by Australian based banks is inconsistent with Australia's need, as a capital importing country, to access a diversity of offshore sources of funding." The AFCF went on to state that:

> "the continuing application of interest withholding tax on financial institutions' borrowing offshore sits uneasily with the Government's desire to develop Australia as a leading financial centre and is putting Australia at a competitive disadvantage with respect to overseas financial centres."

Accordingly, the Johnson Report recommended that interest withholding tax be removed on interest paid:

- on foreign-raised funding by Australian banks;
- to foreign banks by Australian branches; and
- on related party borrowings by financial institutions.

This recommendation was in accordance with that provided by the Henry Tax Review.

The Government, in the 2010-11 Federal Budget, announced that it would phase down the interest withholding tax paid:

- by foreign bank branches to head office to 2.5% from 2013-14 and 0% from 2014-15;
- by other financial institutions/borrowings to 7.5% from 2013-14 and 5% from 2014-15.

On 23 November 2011, the then Assistant Treasurer announced that the phasing down of interest withholding tax would be deferred by one year.

The Coalition's "Our Plan for Real Action" document states at page 30 that the Coalition would "give priority to the recommendations of the Johnson Report into Australia as a Financial Centre." The withholding tax recommendation is a core component of the Johnson Report package and the phase-down of interest withholding tax is consistent with the Coalition's key policy document.

As previously advised, AFMA maintains that the phase-down of interest withholding tax is important to banking competition and to allow Australian business to fund continued expansion. As a nation that relies on the importation of capital to ensure continued growth, it is incongruous that the Government persists with a measure that significantly hinders the free movement of capital into Australia and ultimately causes Australian businesses to pay a higher rate for debt finance, ultimately rendering such businesses less competitive relative to their global peers. The measure appears to have been

dismissed by the Government due to a perception that it was to be funded through the proceeds of the Minerals Resources Rent Tax. AFMA urges the Government to adopt an alternate approach, that is to acknowledge the recommendations of the Johnson Report and consider the effect of the phase-down of interest withholding tax for the wider economy, not merely dismiss the measure due to a perception as to how it was to be funded.

2. Capital Protected Borrowing Rules

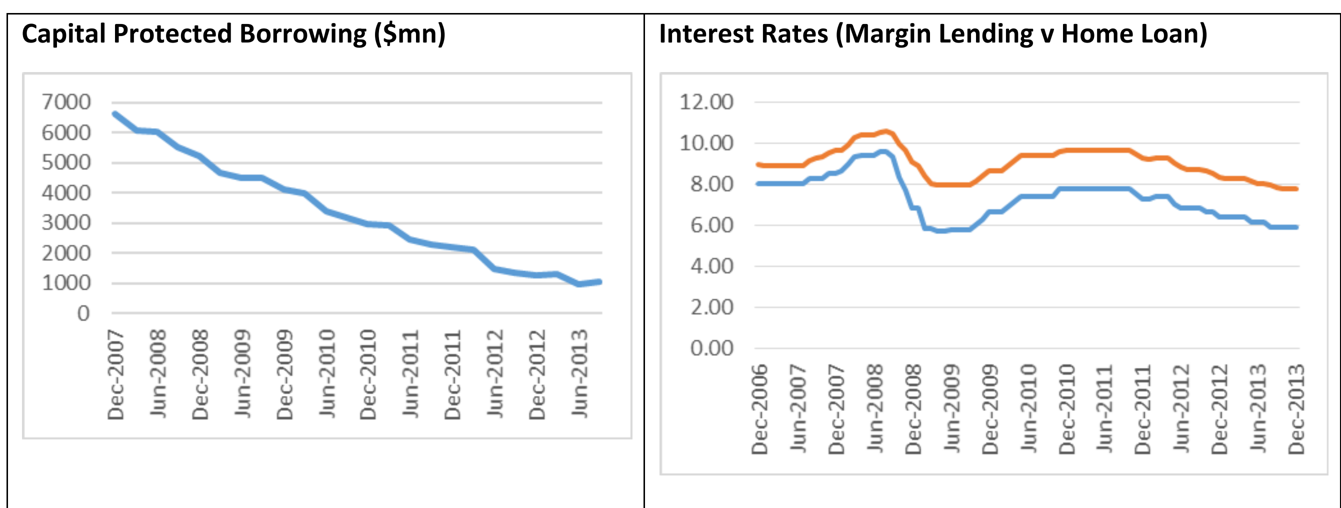
Capital protected products include protected equity loans and instalment warrants. They are an efficient investment tool for retail investors, including many retirees, to manage their financial risk and grow their wealth in a prudent way by investing in the Australian economy.

Schedule 2 of the *Tax Laws Amendment (2010 Measures No. 5) Act 2011* (**TLAB5**) reduced the benchmark rate for the tax deductibility on interest on capital protected borrowings to the indicator home loan rate plus 100 basis points. AFMA advised the Senate Economics Legislation Committee in its inquiry into the related Bill that this level is not a fair reflection of the borrowing costs for investors and it would continue to stymie the market's ability to meet their needs in a cost effective way. Subsequent evidence confirms that our concerns were valid and investors have lost access to cost effective capital protection at the very time that market volatility places a premium on this.

Table 1, set out below, highlights the inefficiencies associated with the reduction of the benchmark rate as set out in TLAB5, namely:

> **Volume** - A continuous decline in market size since the Government announced a greatly reduced benchmark rate in the May 2008 Budget, with total capital protected borrowing amounts in December 2013 exhibiting a reduction of approximately 80% from the peak (December 2007); and
>
> **Price** - The non-deductibility penalty has increased, as illustrated by the increase in the spread between the Margin Lending Rate and the Home Loan Rate between 2007 (average spread of 85-90bbps) and 2013 (spread of approximately 195-210 bps).

Table 1 *(Source – Reserve Bank of Australia Tables F5 and B10)*



In terms of what is an appropriate rate, AFMA agrees with the view provided to the Senate Committee by Treasury, namely that the objective of the benchmark rate is to strike a balance between not inhibiting use of capital protected borrowings and not stimulating the product by affording them an overly generous tax treatment. Clearly, as evidenced by the Tables above, this balance has not been struck by the current rate.

The current, restrictive rate is entirely inconsistent with the Government's deregulation agenda and adds a layer of complexity and red-tape to investors seeking to protect their investment. Anecdotal evidence from our members suggest that investors are having to spend time and money in completing their tax returns in order to make adjustments for amounts frequently less than a couple of hundred dollars and that this is a disincentive to obtain protection. Changing the rate to one which only affects those investors seeking to claim a deduction that may be perceived as "over-generous" will ensure that the vast majority of investors are not burdened by the compliance costs associated with applying the capital protected borrowing rules.

This was a point agreed with by the Coalition Senators in their Dissenting Report to the Report by the Senate Economics Committee review of TLAB 5, which stated:

> "More persuasive is the establishment of a benchmark rate at the midpoint between the indicator rates for standard variable rate housing loans and personal unsecured variable rate loans, as recommended by the Australian Financial Markets Association. This is an attempt to set a level that equates the cost of the component required for capital protection equivalent to the cost of acquiring separate protection. Given this was the original goal of the legislation in establishing a threshold, it would seem to the Coalition to be the more sensible approach."

Taking into consideration the Government's stated objective of reducing red-tape for both issuers and investors, AFMA acknowledges that another viable option may be to consider setting the deductible rate as equivalent to the margin lending rate. While the margin lending rate is significantly lower than the mid-point between the indicator rates for housing loans and personal unsecured variable rate loans, it has the advantage of being easily obtained and reflective of the real cost of funds associated with investors looking to gear into listed equities and other similar assets. However, the Government needs to be aware that providers of capital protected products take higher credit risk on the holder of the products insofar as the protection cost is generally paid by the investor annually in arrears. As such, the margin lending rate understates the real financing cost associated with such products.

We reiterate that the Government should acknowledge the problem and look to make amendments in the 2014-15 Budget. Under the current rules, investors face higher compliance costs, additional taxation on their investments and a tax bias towards riskier investments, which given current market volatility, is counter-intuitive from a policy perspective. AFMA is seeking a solution that would provide a stable and workable solution that protects tax revenue, enable investors to go about their business in a prudent manner and reduce the likelihood of inadvertent impacts on business.

3. Release of the Board of Taxation Report into Permanent Establishments

In April 2013, the Board of Taxation provided its report into the tax arrangements applying to permanent establishments to the Assistant Treasurer. This Report will set out the Board's view as to the advantages and disadvantages associated with the adoption of the functionally separate entity approach in the determination of profits attributable to a permanent establishment, both under Australia's domestic law and also in the network of Double Tax Treaties.

Further, and importantly for AFMA and its members, the Report will contain the Board's view on the continued appropriateness of the "LIBOR Cap," which is a statutory provision that operates to deny deductibility of interest for an Australian branch of a foreign bank above the applicable LIBOR. AFMA further expects that the Report will include commentary and recommendations around Part IIIB of the 1936 Act, which operates as a code for the taxation of Australian branches of foreign banks.

AFMA provided a detailed submission to the Board and is of the view that the contents of the Board's report are vitally important in terms of Australia's policy response to branch taxation. This is particularly the case given that many of the issues that were canvassed by the Board will be considered deeply during the G-20 process in 2014, under Australia's Chair. It is inappropriate that the contents of the Board's report and the Government's policy response have not been publicly released in the nine months since the report's delivery.

In relation to the particular policy positions expected to be included in the Board' report, AFMA maintains that the LIBOR Cap unnecessarily inhibits the flow of capital into Australia through foreign bank branches and, therefore, increases pressure on the availability and cost of credit to Australian business. It is defective tax policy because it conflicts with internationally accepted transfer pricing norms that rely on arm's length pricing. It also has serious technical flaws, most notably because it is not a representative funding rate for individual banks or for funding at a maturity greater than twelve months.

The absurdity of the LIBOR Cap was exacerbated in 2013 when the British Bankers Association ceased to quote AUD LIBOR. This resulted in a situation whereby there was no applicable LIBOR in respect of AUD borrowings and consequently, in AFMA's view, no cap on the deductibility of interest where the Australian branch borrowed in AUD. AFMA alerted Treasury to this issue in advance of the cessation of AUD LIBOR but has had no substantive response. Regardless, the maintenance of a tax technical provision which is ineffective where the Australian branch borrows in Australian dollars is clearly untenable.

Accordingly, AFMA requests that the Government releases the Board of Taxation report into the tax arrangements applying to permanent establishments and acts on any recommendations contained therein.

4. Tax Agents Services Act

In June 2013, the Government introduced the *Tax Laws Amendment (2013 Measures No. 3) Bill* into the House of Representatives. This Bill encompasses amendments to the

Tax Agent Services Act so as to bring financial advisers that offer "tax (financial) advice services" within the regulatory oversight of the Tax Practitioners Board.

Importantly, this Bill extended the existing carve-out for financial advisers that was granted at the commencement of the *Tax Agent Services Act* to 30 June 2014. Subsequently, there is a three year transitional period under which financial advisers that are providing tax (financial) advice services are required to register with the TPB and adhere to the professional standards imposed by the Board.

As the Government is aware, the transitional period was initially scheduled to commence on 1 July 2013. However, as was requested by AFMA (together with a significant number of industry bodies), there was a 12 month deferral of the commencement of the transitional period pending the resolution of a number of threshold issues and concerns.

The principal concern that AFMA has regarding the application of the *Tax Agent Services Act* to financial advisers is the proper articulation of the definition of "tax (financial) advice services." AFMA has lodged multiple submissions that address this point, with a summary of the position being that given the definition of a tax (financial) advice service is practically identical to the 2009 definition of "tax advice" in the initial iteration of the *Tax Agent Services Act*, the Government needs to specifically confirm that services which are currently not covered by the carve-out for financial advisers, and do not require to be accompanied with the disclaimer, will not be covered by the definition of a tax (financial) advice service. We understand this to be the Government's intention, but this has not been specifically and publicly stated.

The provision of such clarity by the Government would provide welcome certainty to an industry that is struggling to understand with precision the ambit of the *Tax Agent Services Act*.

5. Taxation of Financial Arrangements

AFMA welcomed the Government providing clarity in late 2013 regarding the status of announced and unenacted taxation measures. While AFMA did not agree with all of the decisions made by Government, we acknowledge that the announcement by the Treasurer and the Assistant Treasurer on 14 December 2013 was in the whole positive and provided industry with requisite certainty and confidence as to whether the matters would proceed to legislation.

We are concerned, however, regarding one particular announcement that was not included on the Government's list of announced yet unenacted measures and is of significant importance to the majority of AFMA members.

On 29 June 2010, the then Assistant Treasurer, the Hon. Nick Sherry, announced "further refinements to the income tax law relating to the Taxation of Financial Arrangements," as set out in Division 230 of the 1997 Act. Of particular interest to the AFMA membership, the Assistant Treasurer announced that Division 230 would be amended such that "the application of Division 230 of the ITAA 1997 to repurchase/securities lending and short sale arrangements results in tax outcomes that are consistent with their economic and commercial substance."

It was envisaged that these changes would align the taxation treatment of repurchase/securities lending transactions with their accounting treatment. Further, the rules would be amended so as to appropriately quantify the taxable gain or loss arising from a short sale.

These measures are of vital importance to support markets and commercial practices with significant volumes. The lack of clarity from the Government as to the status of these measures, let alone their lack of priority, is of significant concern to AFMA.

AFMA requests that the Government confirm that these measures will be legislated imminently with a commencement date being the commencement of application of Division 230 to affected taxpayers and that this announcement be included in the 2014-15 Budget, if not before, and legislated as soon as possible. It is not tenable that transactions that are systemically fundamental to Australia's financial markets occur without legislative certainty to support the taxation treatment.

6. Disclosure of Tax Payable by Large and Multinational Enterprises

On 29 June 2013, the *Tax Laws Amendment (2013 Measures No. 2) Act* received Royal Assent. Included in this Act was the requirement of the Commissioner of Taxation to publish the following information in respect of corporate taxpayers with annual income in excess of $100 million:

- Total income;
- Taxable income; and
- Tax payable.

AFMA lodged a detailed submission to both Treasury and the Senate Standing Committee on Economics which expressed considerable concern with this proposal. Apart from noting that the Government clearly had not made the case for overturning a fundamental tenet of Australia's tax system, that is confidentiality of taxpayer information, we noted that the proposed disclosure would arguably mislead the community and not address the perceived phenomenon of stateless income. Our views were mirrored by eminent bodies such as the Corporate Taxpayers' Association and the Law Council.

AFMA's submission was cited with approval by the Coalition's dissenting report, particularly the comment that:

> "Of greater concern is that the disclosure framework could incentivise taxpayers to adopt structures that reduce total income to below $100 million so as to escape the disclosure requirement."

As expressed in our submissions, AFMA believes that the information that is currently provided to the ATO through both the annual Income Tax Return and Schedules and also through compliance products such as Pre-Compliance Reviews should allow the ATO to conduct appropriate compliance activities and prosecute those that have not adhered to their obligations with all of the powers available to the ATO as the administrator of Australia's tax system. The ATO is similarly well-placed to discharge the other purported policy basis for the disclosure of confidential taxpayer information, being to educate the public regarding taxation matters and policies.

We note that the mandatory disclosure of taxpayer information to the public based on an arbitrary threshold is out of step with other G-20 and OECD nations. AFMA agrees that increased transparency of taxpayers' affairs will assist in preventing practices that may be perceived as egregious, but such transparency should not occur through disclosure to the public in a misleading fashion.

In advance of the first disclosure by the Commissioner of taxpayer information, the Government now has an opportunity to remedy the inherently flawed proposal set out in *Tax Laws Amendment (2013 Measures No. 2) Act*. AFMA urges the Government to pare back the disclosure requirements of the Commissioner and to restore the confidentiality of taxpayer information.

7. Specific Deduction for Liquidity Management Costs for Financial Institutions

A fundamental pillar of the financial institution reforms under the Third Basel Accord (**Basel III**) in respect of the prudential regulation of financial institutions is the requirement that financial institutions hold sufficient high-quality liquid assets to cover events of stress. Financial institutions will demonstrate adherence to the principle through compliance with two prescriptive ratios: the "Liquidity Coverage Ratio" and the "Net Stable Finding" ratio.

The maintenance of a sufficient pool of liquid assets to adhere to the Basel III requirements generally results in a significant cost for the financial institutions, properly characterised as a net interest expense. This is due to the fact that interest paid on the funding used to acquire the liquid assets is typically higher than the return on the investments themselves.

Historically, it has been common for multinational financial institutions to adopt a model whereby management of the liquidity requirements for the ADI has been performed centrally, with the costs of adherence being allocated to the businesses/jurisdictions that give rise to the requirement for the bank to hold the pool of liquid assets. This model of centralisation of liquidity requirements is consistent with that expressed by the Basel Committee on Banking Supervision, as set out in the document "Principles for Sound Liquidity Risk Management and Supervision." This document states that "a bank should actively monitor and control liquidity risk exposures and funding needs within and across legal entities, business lines and currencies, taking into account legal, regulatory and operational limitations to the transferability of liquidity." Accordingly, in order to comply with best practice, financial institutions that operate in a number of jurisdictions and centralise their liquidity management function seek to allocate the costs of liquidity management proportionately to the jurisdictions in which the financial institution operates.

From a taxation perspective, the economic cost that is incurred from holding the pool of liquid assets should generally be deductible, to the extent that the loss or outgoing is best characterised as the net costs incurred by the institution in holding those the liquid assets. Where a financial institution is managing its liquidity requirements centrally and then allocating the associated costs proportionately, then the allocation ought to be deductible to the financial institution in the jurisdiction in which it operates, subject to adherence to transfer pricing requirements.

However, the ATO, in Interpretative Decision ATO ID 2012/92, has set out its view of the taxation consequences of centralised liquidity management being undertaken by the head office of a multinational financial institution and the allocation of costs to the branches of that institution. The view expressed by the ATO in ATO ID 2012/92 is that, in determining the profits attributable to the foreign bank's Australian branch, the net interest expense incurred by the bank on its borrowings to fund the liquid assets is not deductible under Section 8-1 of the *Income Tax Assessment Act 1997*. The practical application of this view is that any allocation of the net costs of complying with liquidity standards by the bank to the Australian branch is not deductible. Importantly, such a conclusion will arise regardless as to whether the allocation of the net costs is at arm's length and accords to transfer pricing principles.

AFMA strongly disagrees with the technical position adopted by the ATO. The fact that the liquid assets are held by the global bank in order for it to continue to be licensed in each jurisdiction that it operates, including Australia, leads AFMA to conclude that any costs associated with the holding of such assets are necessarily incurred to allow the Australian branch to carry on a banking business. That is, without the liquid assets being held globally, the branch would be unable to carry on business in Australia. The allocation of the costs by head office to the branch should not alter whether or not the costs are incurred; rather the issue should be, in AFMA's view, whether the allocation is appropriate having regard to transfer pricing requirements.

The stance adopted by the ATO potentially gives rise to double taxation and will increase the already significant costs to financial institutions that are compelled to comply with the Basel III liquidity requirements. It is contrary to the policy objectives of banking regulation – while the Basel III objectives would be to encourage financial institutions to hold more liquid assets to better insulate deposit-holders during times of stress, the view adopted by the ATO discourages the holding of these assets through exacerbating their cost through double taxation.

Given the ATO view, AFMA submits that the Government should acknowledge that costs incurred by a financial institution that are referable to the Australian operations of that financial institution, whether incurred directly or allocated to the Australian operations under a centralised model, should be deductible in Australia, with such deduction being limited to the arm's length amount determined with reference to transfer pricing principles as set out in Division 815 of the *Income Tax Assessment Act 1997* and, where relevant, Australia's network of double taxation treaties.

Such a legislative clarification would, in AFMA's view, ensure that Australia is not out of step when compared to other OECD and G-20 nations regarding their stance to adherence to the Basel III liquidity requirements.

8. Withholding Tax on Interest Paid to CCPs

In February 2013, AFMA, the Australian Bankers' Association and the Financial Services Council lodged a submission with Treasury seeking a withholding tax exemption for interest paid to Central Counterparties (**CCPs**).

As part of the G-20's commitment to improving the transparency of OTC derivatives, systemically important OTC derivatives (such as AUD interest rate swaps) are required to

be collateralised and cleared through an appropriately structured CCP. The concern expressed in the submission was that where the CCP was located outside of Australia, interest paid on the collateral could result in Australian interest withholding tax.

The submission sought an exemption for any withholding tax that would arise, on the basis that the cross-border interest flow arose solely due to regulatory reform and any withholding tax arising would adversely affect the Australian derivatives market, with the detrimental impacts vastly exceeding any Government revenue.

AFMA has received no response from Treasury with respect to the submission. This issue continues to be an ongoing threat to the Australian derivatives market and AFMA urges the Government to consider the request made in the submission in the 2014-15 Federal Budget.

9. Tax Black Hole for Retail Investors

An expense in relation to an income earning activity that is not recognised for tax purposes (e.g. a deduction, depreciation or inclusion in capital gains tax cost base) is referred to as a tax black hole. It is widely accepted that a tax black hole is a sign of a deficiency in the efficiency and fairness of our tax system.

AFMA's pre-Budget submission in February 2010 asked the Government to introduce a solution in the 2010-11 Budget for a tax black hole that penalises retail investors. In short, the tax black hole in question exists in relation to non-deductible interest on an investment where a capital gain is not achieved when the investment is realised, which could adversely affect many retail investors in commonly offered financial products.

In response, the Assistant Treasurer advised that the Government had considered AFMA's proposal in framing its 2010-11 Budget but would not proceed with it at that stage due to other priorities. He went on to say that the Government may be in a position to consider AFMA's proposal further in the future.

As noted in AFMA's pre-Budget submission from January 2013, we continue to believe it would be timely for the Government to address this issue as a matter of urgency as:

- There is no obvious public policy reason why a tax attribute should not arise in the circumstances considered here and change is required to produce a reasonable and fair outcome for investors;
- Financial market and economic conditions continue to be challenging for retail investors; and
- The issue has already been set aside for four years and, even if a decision is announced in the 2014-15 Budget to make the necessary change, it is unlikely that legislation would be in place before the end of the year.

10. Tax Black Hole – Staff Termination Payments

The Government and the community expect companies to look after the welfare of their staff. The closure of a business can be a distressing time for employees and companies may endeavour to make redundancy payments in excess of minimum statutory entitlements to assist affected employees. The tax law should not inhibit employers who wish to help their staff in this way. However, staff termination payments made to

employees upon the closure of a business may not always be tax deductible to the employer, creating a tax expenditure black hole.

In technical terms, the problem arises from the interaction of s.40-880 and s.25-50 with s.26-55 of the 1936 Act; the latter limits the tax deductibility of a pension, gratuity or retiring allowance paid to an employee. Taxation Ruling TR 2011/6 includes an example that explains ATO's view of the law*:*

> ***Example 34***
>
> *Company T made a payment to an employee in the form of a retiring allowance which meets the conditions for a deduction under section 25-50. However, the payment resulted in the company making a loss for income tax purposes. Paragraph 26-55(1)(a) limits the deduction otherwise available under section 25-50 if the deduction creates or increases a loss for income tax purposes.*
>
> *As a result, the part of the payment to the employee that created the loss is not deductible under section 25-50. As paragraph 26-55(1)(a) expressly prevents part of the payment being deductible under section 25-50, paragraph 40-880(5)(h) excludes that part of the payment from deductibility under section 40-880.*

We believe this outcome conflicts with good tax and social policy. The Ralph Review of Business Taxation considered the tax policy issues and recommended that business closure costs should be made deductible to eliminate a tax expenditure black hole.[1] Staff termination costs may be a significant component of the cost of winding-up a business and they should be fully tax deductible. This outcome is also anomalous given the treatment of related expenditures (eg legal advice on a terminations payment is tax deductible).

Staff termination payments arising in the normal course of winding up a business should be fully deductible. We ask the Government to clarify that its policy is that all *bona fide* staff termination payments are deductible and, if necessary, it should amend the law to provide the required certainty. If there is any concern about tax avoidance, then this should be dealt with separately.

[1] *A Tax System Redesigned*; recommendation 4.14.