



Re:think

Tax Discussion Paper – NAB's submission

June 2015

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1. Introduction

National Australia Bank Limited (NAB) is pleased to make a submission in response to the Tax Discussion Paper (Discussion Paper) which is the first step in a national conversation on tax reform. As a member of the Australian Bankers' Association (ABA), NAB has contributed to the preparation of the ABA's submission and is broadly supportive of its contents.

The Discussion Paper is appropriately themed ***Better tax system, better Australia***. To this end, NAB considers that a better Australian tax system would exhibit the following key features:

- Be *simpler*, especially for small businesses, which would free up capacity for Australians to spend more time innovating and acting as entrepreneurs.
- Be *attractive for savings and investment*, which will ensure the Australian economy continues to be adequately supported by investment and Australians continue to save for their retirement.
- Encourages *increased productive activity* and *more workplace participation* but ensures the *transitional impacts* of any tax changes *are managed fairly*.
- Provides incentives for the creation of *smarter and more innovative Australian businesses*.
- Be *robust against tax avoidance* while not *hindering legitimate commercial activity*.

NAB also considers that *increased certainty around future tax policy direction* would increase the confidence of Australians in the tax system.

2. Australia's Tax System Complexity

NAB considers that the existing tax system has become unnecessarily complex and would benefit from simplification. The objective should be to reduce the costs of compliance, particularly for small business.

Australia's existing tax system is far too complex

Australia's Income Tax legislation covers three volumes and nearly 7,600 pages. However, this is only part of the necessary process in understanding and complying with Australia's income tax system. Income tax legislation is also usually impacted by the interpretations of both the Australian Taxation Office (ATO) and the courts.

In this light, a review of the ATO's legal database shows that the following ATO interpretative documents also contribute to the required understanding of Australia's income tax system:

- Interpretative Decisions;
- Rulings and Determinations;
- Bulletins;
- Technical Discussion Papers;
- Law Administration Practice Papers; and
- Taxpayer Alerts.

This ATO literature also runs to thousands of pages in total.

Importantly, the discussion above only provides a brief insight into the complexity and volume of Australia's income tax laws. Many Australian businesses, large and small, will also be exposed to significant additional tax complexity through the need to comply with other indirect taxes such as the Goods and Services Taxes (GST) and taxes levied by the various States and Territories.

Opportunities for tax simplification

NAB believes that all levels of Government should be bold and ambitious in simplifying Australia's income tax laws and the interactions of taxpayers with these laws. Accordingly, NAB makes the following observations:

- In many countries individuals with simple tax affairs do not need to lodge a tax return. NAB believes this should continue to be the ambition for Australia where those individuals with simple tax affairs are either relieved from a tax filing obligation or their required interaction with the tax system is very minimal.
- Governments should be resolute in seeking to significantly relieve the tax compliance burden on Australia's small businesses. For example, every small business with simple product and service offerings should have a corresponding simple interaction with the tax system. This may be achieved by further investigating ways to reflect more simplicity in the tax laws and boldly investigating ways that tax paperwork can be eliminated (or drastically reduced) for these businesses (for example, through greater use of emerging payments and other digital technology – see Chapter 7 Small Business).

- The volume and complexity of Australia’s tax laws should be critically examined. The questions that should be asked are:
 - i) Is the length and complexity appropriate for the actual taxpayer that needs to read, understand and comply with the tax legislation? (e.g. taxpayers with simple affairs should only be exposed to a corresponding simple tax compliance experience)
 - ii) Is the compliance burden for taxpayers commensurate with the underlying tax risks and can the substantiation requested be extracted from existing business records (especially those produced digitally)?
- As part of the tax reform process, Treasury and ATO should carry out a wide ranging “best practice” review of the tax treatment of business entities, industries and products across the OECD membership. For example, Australia’s small business segment may benefit from a best practice tax system which reduces compliance costs to the absolute minimum, appropriately rewards and recognises business risk taking and entrepreneurship and the particular characteristics of the small business environment (e.g. possibility of losses in the start-up phase). The review should consider the best features of OECD member small business tax systems to arrive at best practice Australian small business tax rules.

Further specific comments around small business tax compliance costs are made in Chapter 7.

Recommendations

1. Taxpayers with simple tax affairs should have corresponding simple tax compliance obligations through the further development of alternative tax compliance approaches and greater use of emerging digital technologies.
2. The best practice approaches of other OECD countries should be considered to reduce compliance costs for business, particularly small business.

3. Individuals

NAB considers that the current fringe benefits tax (FBT) system is unnecessarily complex leading to disproportionately high compliance costs for employers. Opportunities exist to simplify the current arrangements by taxing salary packaged benefits in the hands of the relevant employee and by limiting the fringe benefits tax system to certain employment related fringe benefits that arise in the course of employment.

Taxing Fringe Benefits – A better, more efficient way

The taxation of fringe benefits under Australia’s tax laws is extremely complex. This complexity gives rise to significant compliance costs which are vastly disproportionate to the amount of tax revenue raised.

NAB Case Study

NAB’s experience in complying with the FBT and income tax laws is instructive. It costs NAB approximately \$1m in compliance costs in order to lodge an annual FBT return and populate employee payment summaries with fringe benefits provided. The FBT paid to the ATO by NAB is around \$20m per annum on average. In contrast, NAB’s consolidated income tax return costs approximately \$2.5m in compliance costs to prepare and lodge. However, for this compliance cost spend NAB pays approximately \$2 billion in income tax to the ATO annually.

It is recognised that the FBT regime acts a significant integrity measure to prevent the structuring of preferentially tax benefits to employees and as such the importance of an FBT regime is acknowledged and should not just be measured in terms of revenue raised. However, the current FBT regime is overly complicated and imposes significant administration and compliance costs on Australian employers. A more balanced regime can be achieved that continues to meet the integrity requirements but minimises the compliance costs to Australian businesses.

Opportunities to simply the FBT regime

In relation to FBT, the Henry Tax Review proposed that salary packaged benefits and benefits provided in substitute or to enhance salary be taxed in the hands of the employee at their marginal tax rate. Only employment related benefits would remain subject to FBT in the hands of the employer. NAB would endorse these recommendations proposed in the Henry Tax Review.¹

Fringe benefits provided to employees can generally be broken into the following two categories:

- salary packaged or employee chosen benefits (i.e. benefits provided in substitution of salary or wages) or benefits provided to enhance salary (i.e. incentive benefits); and
- employment related benefits (i.e. benefits received as a result of the employee performing their ordinary employment related duties).

NAB argues a fairer and more equitable FBT regime would be one that:

- taxes those benefits that the employee chooses to take as benefits that replace salary, in the employee’s hands; and
- taxes those benefits that are considered to be directly related to the employee’s work related activities at the employer level.

¹ See Recommendation 9 in Australia’s Future Tax System Review Panel 2009, *Australia’s Future Tax System*, Report to the Treasurer, December 2009, p82

The benefits of a clearly delineated FBT regime would be:

- Removal of the current inequality against lower income earners. Under the current regime, FBT is imposed at the top marginal rate which means any legitimate salary packaging is predominately of benefit only to higher income earners (i.e. to those on the top marginal rate of personal tax). Given the high FBT rate, employees on lower marginal tax rates are effectively precluded from participating in salary package arrangements which benefit their typical tax scales. If packaged benefits were taxed in the hands of employees this inequality would be removed.
- A reduction in compliance costs for the employer as many exemptions or concessions require declarations by the employee or supporting evidence that is only obtainable by the employee. If the benefits were taxed in the hands of the employee, the employee could self-assess their entitlement to the concessions/exemptions based on their own personal circumstances and the employer is not involved in the personal tax arrangements of the employee and is not required to obtain or maintain the supporting documentation/declarations.
- Often, the provision of employment related benefits are the result of an employee merely performing work related activities as required by their employer. While meeting the definition of a fringe benefit, the employee in many cases can neither control the benefit nor have a choice in participating or receiving the benefit (e.g. attendance at work related functions). These issues would not arise in a delineated taxing regime as benefits would be rightfully taxed in the hands of the employer without any reporting against the particular employee and as such the employee would not be personally disadvantaged. In addition, as there would be no reporting on payment summaries for individual employees, the employer may simplify the process for the current costly and time consuming compliance reporting for these benefits. Reporting these types of benefits on the employee's payment summary presents significant compliance obligations for the employer (given the level of information required to meet the reportable fringe benefits obligations). In this light, sufficient details are generally not available from a single source system (in fact in NAB's situation this information is obtained from in excess of 30 different sources).
- Each time the FBT rate changes, NAB is required to change various internal systems which cause a re-direction of scarce technology resources away from productive and business critical activities. Typically, NAB's technology systems are also only able to be opened a certain number of times a year in order to minimise disruptions to customers and ensure a consistent supply of financial services in a market at any time, with any changes to FBT best made during these windows of opportunity. The multiple changes required to reflect the various additional temporary tax levies introduced for only limited periods of time in recent times has been challenging. A split taxing regime would remove the need for the FBT rate to be matched to the top marginal rate of tax as only employment related benefits would be taxed at the FBT rate in the employer's hands. Therefore temporary levies would not need to be reflected in the FBT rate and thus businesses would not need to incur the unnecessary costs of changing systems to reflect such rate changes.

Recommendations

3. NAB recommends that salary packaged benefits and benefits provided in substitute or to enhance salary are taxed in the hands of the employee at their marginal tax rate. Only employment related benefits should remain subject to FBT in the hands of the employer. The current reportable fringe benefit requirements should be removed.

4. Savings and investment

NAB supports the following principles to shape, direct and guide Australia's tax system for savings and investment:

- a) Australian shareholders who invest in Australian companies should continue to be taxed at their respective tax rates on dividend income received under the existing dividend imputation regime.
- b) A taxpayer's income and expenses should continue to be pooled together regardless of the underlying source of activity giving rise to the income or expense.
- c) Capital gains should continue to receive concessional tax treatment.
- d) Saving for retirement should continue to receive concessional tax treatment (see Chapter 5).

NAB considers that the following enhancements to Australia's tax system for savings and investment would also contribute to a better Australian tax system:

- Mutual recognition of imputation credits between Australia and New Zealand.
- Improving the post-tax outcome for interest income received on bank deposits by individuals.

Lastly, NAB believes that any changes to tax policies impacting savings and investment should be done as a package rather than changing any feature in isolation.

a) Retain Australia's dividend imputation regime

NAB strongly supports the retention of Australia's existing dividend imputation regime.

Australia's dividend imputation system ensures that Australian shareholders who invest in Australian companies are taxed at their own tax rates on dividend income received. That is, there is no minimum tax rate on Australian company dividends and dividends are taxed at the rate applicable to the relevant shareholder. These outcomes provided by dividend imputation have contributed to share ownership being a popular choice for Australians.

Dividend imputation has led to strong capital discipline in Australia

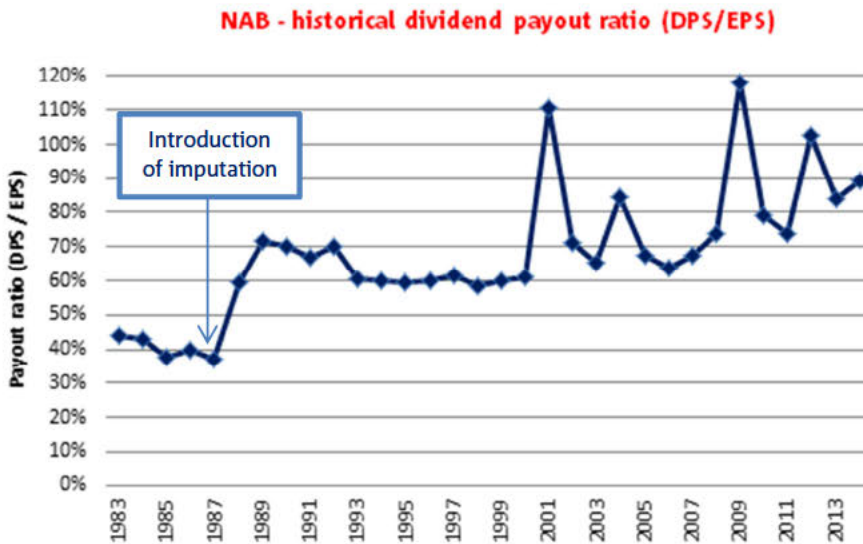
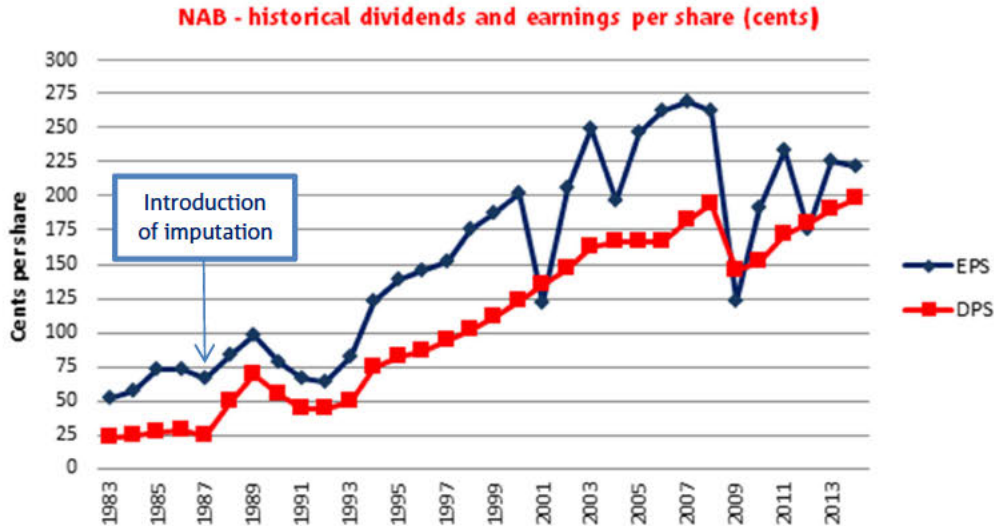
Prior to the introduction of dividend imputation in 1987 the dividend payout ratio of the ASX 200 was around 50%. The payout ratio of the ASX 200 is now closer to 70%.² Goldman Sachs found that despite the quite logical assumption that this higher pay-out ratio would likely have led to lower growth being experienced by the ASX 200 compared to global averages; this has not been the case.³ Specifically, Goldman Sachs notes that despite companies paying out 65% of their earnings over the past decade (which is 25% above the developed market average), Australia's 5% per annum dividend growth has only been slightly below the 6.3% global average and well above the 1% Goldman Sachs calculates that is implied by Australia's pay-out ratio and the growth that has existed globally.⁴

NAB's shareholders have also experienced a similar growth in both NAB's dividend payout ratio and dividend per share since the introduction of imputation in 1987. This data is set out below.

² Matthew Ross, Goldman Sachs Portfolio Strategy Research, "Franking credits; eating away at the 'free lunch'", 28 April 2015

³ Ibid

⁴ Ibid



This achievement of higher dividend growth despite higher dividend payout ratios experienced by NAB and the wider ASX is evidence of the stronger capital discipline fostered by dividend imputation.

Goldman Sachs also reported that dividend imputation has reduced the incentive for Australian companies to gear excessively. They note that Australian corporates currently have total debt to equity of 62% which is low by global standards.⁵

Changes to dividend imputation may lead to a change in capital allocation by Australian companies away from returning capital in the form of dividends to other forms, such as on-market buy backs (the capital management tool of choice in the United States). Such a change may not deliver the strong capital discipline discussed above. This may also cause a move by domestic investors away from yield stocks to more growth-oriented stocks in order to access income in the form of tax advantaged capital gains.

⁵ Matthew Ross, Goldman Sachs Portfolio Strategy Research, "Franking credits; eating away at the 'free lunch'", 28 April 2015

Dividend imputation may act as a bulwark against the forces threatening Australia's corporate tax base

It has been recognised that dividend imputation encourages Australian multinational companies to carry on business activities and derive income in Australia. It follows that in an environment of uncertainty around the effectiveness of the international tax framework,⁶ dividend imputation may act as a bulwark to protect Australia's corporate tax base. As such, any changes to the existing dividend imputation regime would need to be made cognisant of this risk.

NAB experience

Dividend imputation has specifically delivered the following benefits for NAB:

Dividend imputation has contributed to delivering a reliable source of regulatory capital for NAB

NAB's share register has been strongly supported by Australian investors. NAB's shareholder profile is:

- Australian retail investors: 44.8% (comprised of shareholders of all ages and demographics),
- Australian institutional investors: 32.8%; and
- Foreign institutional investors: 22.4%.

Accordingly, NAB's domestic ownership is approximately 77.6%.

The above profile of NAB's share register has been consistent over the period December 2010 to March 2015 as illustrated by the table below.

NAB Shareholder Register Profile⁷

Date	Investor type		
	Domestic Institutional	Foreign Institutional	Retail
Mar 2015	32.8%	22.4%	44.8%
Sep 2014	31.2%	22.3%	46.5%
Sep 2013	31.7%	22.5%	45.7%
Sep 2012	33.8%	22.4%	43.8%
Sep 2011	34.0%	21.8%	44.2%

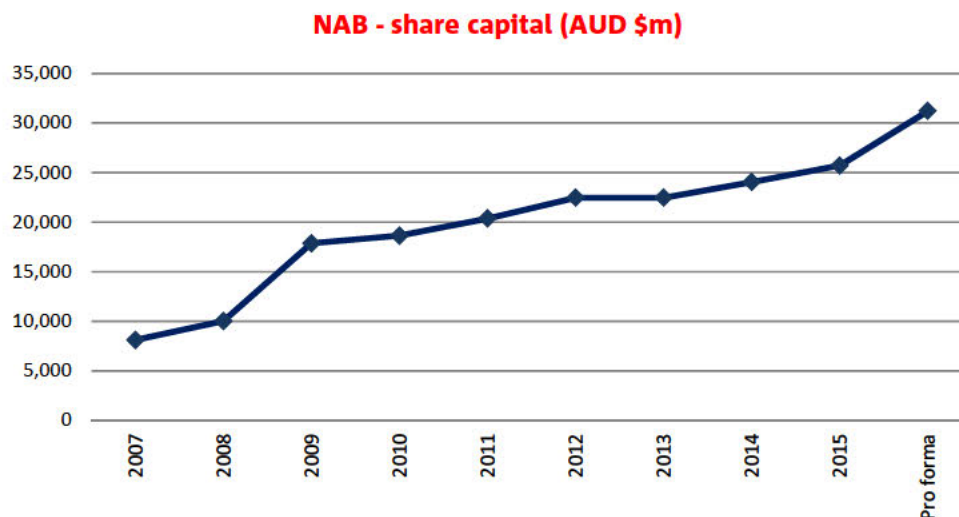
Being able to access a stable reliable pool of capital from domestic shareholders has been important to Australian corporates, such as NAB, over the last few years, especially during the Global Financial Crisis (GFC).

To this end, from 1 October 2007 to 31 March 2015 NAB's total ordinary share capital increased from around \$8 billion to almost \$26 billion. By 30 June 2015 NAB's total ordinary share capital is expected to have increased to in excess of \$31 billion following the completion of the current \$5.5 billion capital raising now in progress.

The year by year growth in capital is set out in the table below:

⁶ In dealing with the emergence of the digital economy and more integrated global business models.

⁷ The above statistics are based on beneficial ownership searches carried out on the largest holders on the register of National Australia Bank ordinary shares. As such, certain assumptions are made concerning the proportion of the register that is not subject to this more detailed analysis.



The key components of this increase are set out below:

Movements – NAB Ordinary Share Capital		\$000
1-Oct-07	Opening Balance	8,110
Various	Conversion of hybrid capital	1,698
2009	Institutional share placement	4,914
2009	Share purchase plan	999
Various	Dividend reinvestment plan	9,311
Various	Equity based compensation	1,402
Various	Treasury share movements	(533)
2015	Rights issue	5,500
Total		31,401

During this period NAB has received strong shareholder support across all shareholder classes.

As noted above, NAB is currently conducting a \$5.5 billion rights issue.⁸ The institutional component of the rights issue has been finalised raising \$2.7 billion of additional ordinary share capital.⁹ A further retail component (which has been fully underwritten) is expected to raise the remaining \$2.8 billion.

In relation to the institutional offer the following key points should be noted:

1. Approximately two thirds of the institutional offer was made to Australian residents and of this population virtually all shareholders accepted the offer.¹⁰
2. Approximately one-third of the institutional offer was made to non-residents of Australia and of this population over 90% accepted the offer.¹¹

⁸ Details of the capital raising were announced on 7 May as part of NAB's 2015 Half Year results

⁹ See 12 May ASX announcement: 'NAB completes the institutional component of its 2 for 25 pro rata accelerated renounceable entitlement offer'. Approximately 97% of eligible institutional shareholders took up their offer.

¹⁰ Domestic Institutions renounced 265,689 rights (being the equivalent of \$8m of new capital)

3. The overall acceptance rate was approximately 97%, with the renounced shares sold into an institutional shortfall book-build where the premium achieved over the offer price was paid to the institutional shareholders that renounced the offer.
4. Overall there was strong investor support from both domestic and foreign shareholders, although overwhelming support came from Australian investors.

The above analysis suggests that for NAB the marginal investor is more likely to be an Australian resident institutional investor rather than the equivalent foreign institutional investor.

Australian investors have also shown strong support for recent Additional Tier 1 hybrid issuances

Under Australian prudential capital rules set by the Australian Prudential Regulatory Authority (APRA), Australian banks are required to hold certain levels of regulatory capital, including Basel 3 compliant Additional Tier 1 (AT1) capital. These prescribed AT1 instruments need to have loss absorption features such as a conversion feature into ordinary capital of the bank, or a write down feature that would extinguish the AT1 obligation if certain regulatory capital events were to occur.

Most AT1 securities issued by Australian banks are classified as “equity interests” for tax purposes and pay franked distributions to investors, who are predominantly Australian residents.

Approximately \$4.6 billion of frankable AT1 securities has been raised by NAB since the introduction of Basel 3 in 2013. The weighted average cash margin on these securities over the 90 day BBSW rate is 2.31%. This is set out in the table below.

NAB frankable AT1 Securities issued since 2013

NAB Basel 3 AT1 Instrument	Capital (\$)	All in margin (including franking credits)	Cash margin paid
NAB CPS 1	1,514	3.20%	2.24%
NAB CPS 2	1,717	3.25%	2.28%
NAB Capital Notes	1,342	3.50%	2.45%
Total	4,574		2.31%

The regulatory capital holding requirements for Australian banks are likely to increase in the future. This is following anticipated new imposts arising from the Financial System Inquiry (FSI) recommendations in this area.¹² It is important in light of this regulatory backdrop to ensure on-going access to a strong domestic investor base. NAB believes that now is not the time for the Government to consider changes to the dividend imputation regime and inject uncertainty and risk into investor considerations in an environment where regulators will likely require Australian banks to hold more capital.¹³

In the event that dividend imputation was removed or significantly changed, it is likely that disruption would occur to the Australian banking AT1 market, with banks facing higher costs of capital to compensate investors for the inability of banks to pay franked distributions on these regulatory capital instruments.

¹¹ Foreign institutions renounced 2,754,863 rights (being the equivalent of \$79m of new capital)

¹² See NAB Chairman, Michael Chaney AO, letter to shareholders on Pro rata Renounceable Entitlement Offer, 8 May 2015

¹³ See speech by APRA Chairman Wayne Byres, COBA CEO & Director Forum, Sydney, 13 May 2015. Available at <http://www.apra.gov.au/Speeches/Pages/Sound-Lending-Standards-and-Adequate-Capital.aspx>.

Based on an assumed 90 day BBSW rate of 2.15% the additional cost to NAB would be approximately \$45m per annum (i.e. approximately 1.0% of the total AT1 capital on issue).

Extrapolated across the entire AT1 market for frankable securities the total cost to the banking industry (and ultimately the economy) that would arise from being unable to frank AT1 securities is estimated to be \$260 million per annum. Given the current historically low interest rates and the expectation that banks would be required to hold greater levels of capital over time, the AT1 cost of removing dividend imputation is expected to increase over time.

b) A taxpayer's income and expenses should continue to be pooled together regardless of the underlying source of income or expense

In Australia the primary unit in the personal tax system is the individual. Under the personal tax system all of the income derived and expenses incurred by an individual are “pooled” together in arriving at the individual's taxable income. That is, there is no bifurcation of income or expenses according to the source of the underlying activity which gave rise to the particular income or expense (e.g. income and expenses attributable to labour are pooled with income and expenses arising from savings and investment).

NAB believes that the above features of the personal tax system should not be changed.

Implicit in the above statement is that if an individual makes a bona fide net loss from an investment activity this should continue to be able to be pooled with other sources of income (and expenses) in arriving at his or her overall taxable income. This pooling would apply regardless of the particular investment type (e.g. shares, residential property).

In relation specifically to the negative gearing of residential property, NAB supports the ABA's comments made in section 5.1 of the ABA's submission.

c) The importance of capital gains concessional tax treatment

NAB believes that capital gains should continue to receive concessional tax treatment at the current discount rate of 50%.

Capital gains taxes (CGT) are often criticised as being economically inefficient. This is because capital gains are taxed on a realisation basis, giving an incentive for the owners of assets to hold on to them to avoid paying the tax rather than selling them to those who value them more highly. Accordingly, this 'lock-in' effect results in a less efficient allocation of the capital stock, reducing productivity and economic growth. Reducing or eliminating CGT unlocks these unrealised capital gains for the benefit of the broader economy.

CGT was introduced, in part, on the basis that the Australian tax base should incorporate the broadest definition of income and to address various anti-avoidance practices prevalent at the time.¹⁴ From 1985-1999 capital gains were taxed at marginal tax rates but with indexing of the cost base and averaging available. It has been argued the pre-1999 CGT regime imposed one of the highest effective tax rates on the disposal of shares among developed countries.¹⁵ In 1999 CGT reforms arising from the Ralph Review of Business Taxation were made which replaced the former regime with a 50% CGT discount for individuals and 33% for trusts.

¹⁴ The 1985 Draft White Paper on the Reform of the Australian Tax System that discussed the possible introduction of a CGT argued that the absence of a CGT was 'at the core of many avoidance arrangements'.

¹⁵ Stephen Kirchner, *Reforming Capital Gains Tax: The Myths and Reality behind Australia's Most Misunderstood Tax*, Centre for Independent Studies Policy Monograph 103 (The Centre for Independent Studies, Sydney, 2009).

Experience suggests that when CGT is reduced gross CGT revenue increases. In the United States, Moore and Kerpen noted that over a 30 year period a consistent pattern emerged: when tax rates on capital gains were cut, gross CGT revenue increased and the opposite occurred when tax rates on capital gains were increased.¹⁶ Kirchner reported a similar trend for Australia that the CGT share of Commonwealth tax revenue nearly doubled in the period 1999-2009 from 3.4% to 6.6%.

NAB believes that the current discounts applying to capital gains derived by individuals and trusts should be retained. Any changes could negatively impact on Australia's attempts to improve productivity. To this end, if Australia's capital stock is immobilised through the lock-in effect of investors deferring realisation of capital gains as a result of higher taxes on gains, the capital will be denied to uses which may make potentially higher rates of return.

d) Mutual recognition of imputation credits between Australia and New Zealand

NAB supports the mutual recognition of Australian and New Zealand imputation credits as a further step towards building closer economic relations between Australia and New Zealand. NAB believes the further integration of Australian and New Zealand capital markets that would arise from the mutual recognition of imputation credits would positively impact both economies.

NAB also supports the submission to the Discussion Paper made by the Australian and New Zealand Leadership Forum on this issue.

e) Interest income received on bank accounts should be concessionally taxed

Under Australia's tax system, interest received by individuals from bank accounts and debt instruments is taxed at full marginal rates with no allowance for inflation. Chart 4.1 on page 60 of the Discussion Paper illustrates the disparity between the nominal effective marginal tax rates applying to interest income compared to other forms of investments.

NAB believes that the impact of inflation should be addressed through this review with the intention to deliver a better post-tax outcome for interest income. This could be achieved by a savings discount similar to Recommendation 14 in the Henry Tax Review.

As part of NAB's initial submission to the FSI, NAB noted that for interest bearing investments, such as deposits, tax was calculated at a marginal tax rate on nominal interest rates.¹⁷ NAB recommended a reduction in the tax bias against deposits "by removing relative tax penalties for interest income which may be achieved by having an offset for inflation and/or a discount rate".¹⁸ NAB continues to hold this view and believes this suggestion should be revisited as part of the Tax Discussion Process.

¹⁶ Stephen Moore and Phil Kerpen, *A Capital Gains Tax Cut: The Key To Economic Recovery*, Policy Report (Lewisville, Texas: Institute for Policy Innovation, October 2001), 14-15

¹⁷ NAB submission to the Financial System Inquiry, March 2014, p10.

¹⁸ NAB submission to the Financial System Inquiry, March 2014, p10.

Recommendations

4. NAB recommends that the dividend imputation system be retained as currently enacted.
5. NAB recommends that taxpayer income and expenditure should continue to be pooled together regardless of the source of the relevant income and expenditure.
6. NAB recommends that capital gains should continue to receive concessional tax treatment.
7. NAB supports the mutual recognition of Australian and New Zealand imputation credits.
8. NAB recommends that concessional tax treatment be introduced for interest income derived by individuals.

5. Tax arrangements for superannuation

As a preliminary comment, NAB submits that any tax changes to the superannuation system be made according to the following principles:

- Any changes support the “objectives” of the system. As previously argued, NAB supports the objectives of the superannuation system being clearly defined.¹⁹ This will provide a framework against which superannuation and related tax and social security policy proposals can be assessed. This will improve stability, and encourage fairness in the allocation of overall concessions.
- Have regard to best practice models in funding the provision of adequate retirement incomes. From a classical viewpoint, the most effective, efficient and fair tax model for a retirement incomes system is a consumption based tax model. This model features tax exempt contributions and tax exempt earnings during the savings phase and tax on income consumed in retirement (accompanied by reasonable integrity measures).
- Be subject to an agreed and robust model to assess the value of tax concessions against the estimated ultimate savings to government revenue through reduced reliance on the age pension (including ancillary benefits).
- Major revisions or changes be assessed against a list of criteria to ensure the change supports the objectives of the system and delivers the intended policy outcomes at an acceptable cost to, or for, the participants in the system.

Properly defining the objectives of the superannuation system

To realise the aspirations of successive governments, NAB recommends the adoption of a number of core and measurable objectives. The overarching summary of these core objectives would be *“improving living standards in retirement whilst reducing the cost of an ageing population to the Government (through the current and future taxpaying population).”*

These policy settings should favour increasing self-provision and, within this framework, incorporate responses which support the transfer of longevity risk from the public to the private sector.

- 1) *Objective 1: Boost the retirement incomes for all working Australians:* This objective can be expanded by stating the following specific targets:
 - A headline target replacement income of 60-70% of full time pre-retirement earnings;
 - The encouragement of income streams at retirement over lump sum withdrawals; and
 - The base of the headline target comprising, at least for a transitional period, the age pension and private earnings (the age pension continuing to act as a safety net).
- 2) *Objective 2: Raise the level of self-sufficiency amongst Australia's retirees:* This can be measured by setting target levels of sufficiency over the longer term comprising:
 - Increasing years of self-provision at a minimum of the age pension rate;
 - Ensuring that a significant majority of the superannuation population is saving to the level needed to fund the age pension over 10, 20, 25 and 30 years; and,

¹⁹ See NAB's submission in response to the Final Report of the Financial System Inquiry, March 2015

- Aspiring to a significant majority at system maturity privately reaching the headline target of 60%-70% pre-retirement earnings for full retirement.²⁰
- 3) *Objective 3: Enhance the outcomes for those who qualify for a government pension:* This relates to the previous objectives. With increasing self-provision, Commonwealth expenditures on the safety net age pension and/or ancillary benefits could increase for the most vulnerable.
 - 4) *Objective 4: Boost the pool of national private savings:* Growth in superannuation savings, both in absolute terms and as a percentage of GDP, could be used to assess this objective.
 - 5) *Objective 5: Establish a regulatory framework that is simple, consistent for all members, and has few rules:* This relates to removal of the complexity within the system and also the efficient management of legacy arrangements.
 - 6) *Objective 6: Superannuation should be the most concessional form of savings given controls on access and long term aims for funding retirement:* This can be measured by ensuring that superannuation remains the most attractive structure for Australians to save for an adequate retirement.

NAB agrees with investigating the fairness and complexity of the system but recommends focusing firstly on the above core guiding principles to ensure more Australians are able to partially or fully self-fund an adequate retirement.

As part of this framework, there needs to be a durable and strong recognition that provision of tax concessions helps Australians to increasingly fund their own retirement including their aged care and health needs.

Consumption based tax model – the best model for fairness and equity

The best practice model for funding adequate levels of replacement income in retirement which is fair and equitable is to exempt contributions, exempt earnings and tax retirees on a consumption basis ([E]xempt, [E]xempt [T]axable) (EET)

As recognised across the OECD, this model would need to have integrity and sustainability measures. These may include either or both contribution and/or account balance caps aligned to the provisions for an adequate retirement along with modified lump sum rules to ensure that retirement benefits are predominantly used to fund the retirees' retirement (or their dependant's needs in the event of earlier death).

Current state

Australia's retirement savings system is recognised as world leading, with Australians able to enjoy an established system that combines voluntary and compulsory savings for retirement with an Age Pension safety net.

Australia's system rates well in any international comparison and its robustness during the financial crisis is testament to its fundamental soundness. The Melbourne Mercer Global Pension Index 2014 ranked Australia second in a comparison of 25 retirement income systems around the world, based on factors such as system design, regulation and governance.²¹

²⁰ If linked to revenue and equity measures, this objective would be capped at an absolute limit, similar to 'Reasonable Benefit Limit' (RBL) subject to indexation at the annuity rate (for longevity management assuming a 'safe withdrawal rate' of 3-4% from a starting asset base).

²¹ The Melbourne Mercer Global Pension Index 2014 ranked Australia second in a comparison of 25 retirement income systems around the world

Notably, when comparing the tax concessions provided to superannuation in Australia, the savings are not overly generous.

The Mercer Tax & Superannuation Benchmarking Australia against the World's Best Retirement Savings System report in February 2013, indicates that six out of the nine countries reviewed have tax regimes that are more generous towards retirement savings than Australia.

“On the global stage, the taxation of Australian’s retirement savings is not overly generous. The research also reveals that the current contribution caps fall significantly short of the other countries. This result raises the question whether the current arrangements provide Australians with the best opportunity to save for a comfortable retirement, whilst also reducing future reliance on the Government.”²²

The Australian system is unique in that it taxes contributions and investment earnings and does not tax benefit payments. The most common taxing method in the OECD is where the contributions and earnings are not taxed, and the income stream in retirement is taxed, usually at the pensioner’s marginal tax rate.

Optimal state

Subject to the implementation of appropriate integrity measures, such as a fund size cap as utilised in the UK, along with modified access rules, the EET model is considered to be the most fair and equitable method for taxing retirement savings.

It is based on the member’s tax rate at the time of consumption, assists with building adequate savings and largely ignores variability in earnings and tax during savings phase. This latter becomes more important as there is increasing volatility in employment participation rates, associated income volatility and emerging evidence of a lowering in the correlation between income and wealth.²³

The delay in the taxing point with a consumption based model also allows retirees to gain the benefit of compounding of the returns, which in time will work to mitigate the retirement savings gap and the impact of the ageing population.

It is recognised and acknowledged that there are barriers to such a significant change given the long gestation of the current system and budgetary pressures. Notwithstanding this, regard should be had to the most valuable qualities of this model when changes to concessions are being considered (within the context of the objectives of the system including social security interactions).

Adopting EET attributes

Responses and approaches to balancing outcomes for the overall population (and future generations) should, in an efficient and effective framework, implicitly recognise year- to- year and even decade- to- decade volatility. Superannuation is a long term proposition requiring savings over a working life of decades to fund increasingly long retirements.

The EET model appropriately enables some smoothing and greater savings towards self-funding an adequate retirement (or enhancing outcomes for those on the aged pension) particularly when there is capacity to do so.

²² The Mercer: Tax and Superannuation: Benchmarking Australia against the world’s best retirement saving systems, 2013

²³ ABS, 6523.0 - Household Income and Income Distribution, Australia, 2011-12, Table 2: Ratio of values at top of selected percentiles, 2011-12 shows that income is more equally distributed than wealth. In 2011-12, the equalised income of households at the top of the 80th percentile (or fourth quintile) was 2.6 times higher than that of households at the top of the 20th percentile (or lowest quintile), whereas wealth was 10 times higher

Of course in a longstanding system, depending upon the appetite for significant change, it is recognised that adopting such a model would require a major investigation of existing tax settings as well as a transitional approach to manage impacts to revenue.

There are also external tax settings that would need to be adjusted. For example, currently the tax free threshold and the Senior Australians Pensioner Tax Offset (SAPTO) combined with the Low Income Tax Offset (LITO) would deliver to most retirees a tax free income in the vicinity of \$35,000 annually.

In any event, the attributes of an EET model which implicitly recognises variability in income and circumstances throughout a working life should form a key part of any revised framework reducing penal tax imposts as incomes fluctuate and/or restrictions on 'catching up' as participation in the workforce waxes and wanes.

The principles underlying the taxation of superannuation

In line with the above proposed superannuation objectives relevant tax principles should:

- Reflect the concept of a target pension for the purposes of defining what is adequate. This is a relative framework focused on replacement rates (as is the full Age Pension which is indexed to Male Total Average Weekly Earnings (MTAWE). Traditionally this target has been set at between 60%-65% of gross pre-retirement income.²⁴
- The age pension and ancillary benefits provided by all tiers of Government are a form of tax concession and should be quantified in order to more properly assess the Tax Expenditure Statement figures in relation to the costs of superannuation concessions, particularly taxes on earnings, and the resulting savings from increasing self-reliance.
- Tax imposed within the superannuation environment should generally not be higher than would have been paid on ordinary income. Given the compulsory nature of the system, superannuation should also remain the most tax effective form of saving for an Australian's retirement.
- Tax rules within super should be consistent with tax rules outside super but at a different rate. If this is not true, then arbitrage opportunities will emerge (e.g. if franking credits are denied within super but maintained outside super, then investing in Australian equity inside super will fall away).
- Tax rules should be consistent and without duplication. There should be broad tax neutrality across fund structures (acknowledging that there will be different approaches to attribution in vehicles that 'pool assets'). For example, it is not appropriate that only in a life policy backed arrangement a deemed disposal occurs for capital gains purposes on transfer from the complying superannuation to the segregated exempt assets pool.
- Integration of the means tested social security system, superannuation system and tax.

Assessment criteria

To ensure any proposed changes are of overall benefit to the participants in the system, an assessment against the following criteria must be conducted:

- The cost of, or to, participants of implementing change – superannuation funds, members, employers, and government agencies such as the ATO.

²⁴ Senate Select Committee on Superannuation: 2002 Report, *Superannuation and standards of living in retirement - the desirable target for a person on average earnings is a replacement rate of 70-80 per cent of pre-retirement expenditure (which equates to approximately 60-65 per cent of gross pre-retirement income)*... - it would be higher for those on average weekly earnings and lower for those on higher incomes.

- The impact to Commonwealth tax revenue over the longer term, including beyond the forward estimates.
- The impact to the retirement savings gap.
- Substitution effects – existing frameworks versus new. Changes to tax rates on superannuation within the fund (including moves towards an EET model or an alignment of earnings taxes across savings and pension phases) requires assessment of other tax settings, particularly individual taxes. For example, SAPTO and LITO provide individuals with tax free income from investments subject to tax outside superannuation. If an earnings tax was introduced in pension phase and these offsets apply, it would be sensible to exit a proportion of capital each year from the superannuation system to alternative investments.
- Relative attractiveness of superannuation overall. Behavioural changes may drive investment into other options diminishing the overall value and role of superannuation at both a macro as well as individual level.
- Ongoing workforce participation. Settings should contemplate options which encourage ongoing participation in the workforce. For example, simple Pension Bonus schemes for those who continue working and would otherwise be eligible for the Age Pension.
- Conversion of superannuation balances into retirement incomes with features mitigating risks, particularly for longevity. Currently, there is a disincentive to convert superannuation savings into some longevity management options such as ‘deferred income streams’ due to tax settings.

Implementation considerations

- Super funds cannot practically tax the investment income of different members in a different way e.g. a higher tax on members with income greater than a defined amount within the super environment.
- Super funds cannot practically have different contribution tax rates for different members e.g. members earning above \$300,000. These arrangements need to continue to be managed by the ATO and, in time, aligned to the Super Stream reporting standards.
- Special case differences should be avoided or be attended by appropriate sunset clauses (e.g. 1988 funding credits).
- Transition or quarantining measures to ensure equity and mitigate adverse impacts should be simple.
- Assessment of change impacts should be conducted across the various participants including the funds and their agents as well as departments/agencies such as the ATO.

6. General Business Tax Issues

Encouragement of productive activity and more workplace participation

A better tax system would encourage increased productive activity and greater workplace participation but ensure the transitional impacts of any tax changes are managed fairly.

NAB notes that academic literature is quite well settled that some forms of taxation have larger negative and distortionary impacts on the Australian economy than others.

To this end, the Discussion Paper includes Chart 2.9 on page 25 which plots various taxes on a sliding scale according to their negative impact on the Australian economy. These in descending order of negative impact are:

- Stamp duties on conveyances;
- Company income taxes;
- Insurance duty (not plotted on Chart 2.9 but separately mentioned);
- Labour income taxes;
- GST; and
- Land Tax.

It is clear from the Discussion Paper that Australia's actual overall tax mix spread across the Commonwealth, State/Territory and local governments does not conform well to an 'optimally efficient' tax mix. This is because Australia's overall tax base is heavily dependent on stamp duties, company and personal income tax and much less so on consumption and land taxes.

NAB in principle supports a tilt in Australia's tax mix towards more efficient taxes which will assist in boosting Australia's productivity and workplace participation. NAB in particular supports a lower company tax rate to support Australia's international competitiveness and promote investment. The Discussion Paper noted that the economic burden of company tax is shared among shareholders, consumers and employees²⁵ and recent Treasury research has found much of the burden of company tax falls on Australian workers.²⁶ A lower company tax rate would also support Australia as a destination for foreign capital with the Discussion Paper finding Australia's current 30% corporate tax rate "is now significantly above the average rate of other countries."²⁷ The Business Council of Australia (BCA) last year found the average statutory OECD company tax rate is 25% and in Asia-Pacific, where Australia competes for investment, the average rate is only 23.5%.²⁸ NAB also supports the ABA's comments on company income tax in section 4.1 of their submission.

NAB also considers any changes to the tax mix should be implemented over a staged timeframe and has appropriate regard for:

- Vulnerable sections of the community that may be impacted by the regressive nature of any new, increased or broadened taxes are appropriately compensated in a way that gives them confidence that the value of any compensation will be permanent and enduring and will not be eroded by future political or policy change.
- Any change which may negatively impact on either asset values or particular sections of the community is transitioned in over a lengthy period of time and otherwise appropriately managed.

²⁵ Tax Discussion Paper, p78

²⁶ Tax Discussion Paper, p26

²⁷ Ibid

²⁸ Business Council of Australia, The Future of Tax: Australia's Current Tax System, September 2014, p17

Encouragement of smarter and more innovative Australian based businesses

NAB believes that various tax incentives for innovation offered globally, especially those offered to the rapidly emerging digital economy, should be reviewed as part of the tax reform process. The ultimate objective should be for a world class offering to be developed to encourage the next Facebook or Google to be formed in Australia, so as to employ Australian staff, receive local investment and contribute to the Australian economy and tax base. Such a review would encompass:

- Incentives for Research & Development (R&D)
- Patent Box schemes
- Venture Capital incentives

NAB notes that innovation is often a principle driver behind increases in productivity. Moreover, firms that innovate are usually more competitive and can sustain more high-skilled and higher paid jobs. Further, there is substantial spillover effect for governments supporting R&D activities.

NAB believes that tax incentives are one of the most effective tools for government to stimulate and attract investment in R&D. To this end, most industrial countries provide some form of general R&D tax incentive. The benefits of an R&D tax incentive over other forms of direct financial support is its simplicity, low administrative and compliance costs, reliability and long term stability.

Interest withholding tax exemption

NAB supports a general exemption from interest withholding tax (IWT) for Australian based financial institution groups (including Australian branches of foreign banks) on interest paid on funds raised from non-residents.

This will likely result in the following benefits:

- Improved access to offshore wholesale funding.
- Improved access to offshore retail deposits.

A general exemption from interest withholding tax on such deposits should allow NAB to attract deposits more widely from international sources (specifically Asia).

Robust Tax Avoidance & Transfer Pricing Rules

NAB believes that the Australian tax system should contain robust rules guarding against tax avoidance and profit shifting but such rules should not hinder legitimate commercial activity. Further, tax compliance obligations which accompany tax avoidance and profit shifting rules should be commensurate with the relevant risk. In order to achieve this outcome NAB believes such rules need to be well drafted and not leave taxpayers uncertain about the tax implications arising from their business activities.

Opportunities to reduce transfer pricing compliance costs

Australia has very robust transfer pricing laws. These laws are coupled with some of the most comprehensive transfer pricing compliance requirements applying across the OECD countries. In addition, transfer pricing compliance obligations will further increase in the next few years with the announcement in the 2015 Federal Budget that multinational companies operating in Australia will also need to meet new OECD international country-by-country reporting.

Aligning Australia's transfer pricing compliance obligations with the OECD transfer pricing documentation standards and replacing current tax return reporting requirements with the new OECD country- by- country reporting requirements would relieve the increasingly excessive regulatory burden faced by multinational companies operating in Australia. Once the 2015 Federal Budget's proposals are legislated Australia will likely have the most onerous documentation requirements applying across OECD countries. NAB considers that the creation of new OECD transfer pricing documentation provides the ATO and Government with an opportunity for a critical rethink of where Australia should appropriately sit in the trade-off between enforcing compliance and not hindering legitimate commercial activity. One particular transfer pricing compliance requirement that may require such a critical rethink is the International Dealings Schedule.

NAB considers that having a transfer pricing compliance framework based on the OECD consensus would reduce the burden on multinational companies operating in Australia because similar rules will likely apply across the OECD. This would mean compliance systems and process can be utilised across the numerous countries in which a multinational group operates. In addition, the proposal would address some of the current uncertainty in Australian documentation requirements.

7. Small Business

Possible use of emerging technology to reduce small business tax compliance obligations

NAB's December 2014 'A Deregulation Plan for Australian SMEs' detailed research showing how regulatory compliance costs generally fall proportionally more on SMEs than larger organisations and how this also extended to taxation.²⁹ The 2009 Henry Tax Review also noted that "small businesses bear a disproportionately higher share of the tax compliance burden".³⁰

Feedback to NAB from customers and SME industry groups is that the preparation of Business Activity Statements (BAS) and income tax returns remain a persistent pain point among small businesses and a significant source of compliance. With this in mind, in the December 2014 'A Deregulation Plan for Australian SMEs' NAB recommended that consideration be given to whether the ATO and banks could work together to harness current and emerging payments technology to eliminate or simplify the requirements for SMEs to lodge BAS and income tax returns.³¹ The example NAB provided was that a coffee shop's business bank account could possibly be configured such that all payments in and out were within the GST system. At the end of each day the bank would settle the coffee shop's GST liability to the ATO on that day's net takings (or process a refund from the ATO if for that day the coffee shop actually lost money). If a standard income tax rate also was to apply to the coffee shop then income tax could also be remitted on a daily basis (and conversely refunds if the trading day gave rise to a tax loss).

This idea has been well received and discussed with the Federal Government, Opposition, ATO and Federal Treasury since the publication of the Deregulation Plan. The discussions have focused on how the idea could work in practice. The general approach discussed has been the possibility of an SME customer allocating their transactions online through internet banking into categories. The labels of these categories could align with current BAS labels utilised by the ATO. This alignment means banks could then remit the completed data (which has been self-verified by the SME customer) directly to the ATO on their behalf, fulfilling the SME's BAS requirements by utilising existing data without them needing to submit a separate BAS form to the ATO. This would likely lead to a significant reduction in the SME's tax compliance costs. Even small reductions at the individual firm level could have a significant overall impact on SMEs and deliver productivity and employment benefits to the broader Australian economy.

Currently there is not the technology capability at either NAB or the ATO for a process described above to occur but envisaged improvements in technology means the idea should continue to be explored as this capability could be available in the future. The opportunity to effectively remove tax compliance obligations for many Australian small businesses is a significant prize worth pursuing.

NAB continues to believe that Government sponsorship of a working group – convened by the ATO and with representatives from the banking and payments industry to consult on this broader idea of utilising the existing and future payment systems to lower compliance costs for SMEs – is a worthwhile idea. We believe the idea is also worthy of consideration and debate through the Tax White Paper process and NAB welcomes the opportunity to discuss it further.

²⁹ National Australia Bank 'A Deregulation Plan for Australian SMEs', December 2014, 'Taxation' p13, available at <http://business.nab.com.au/wp-content/uploads/2014/12/nabs-deregulation-plan-for-australian-smes-december-2014-pdf.pdf>

³⁰ Australia's Future Tax System Review Panel 2009, *Australia's Future Tax System*, Report to the Treasurer, December 2009, Part One: Overview, p67

³¹ See 'A Deregulation Plan for Australian SMEs', Recommendation 2, p6.