6 November 2002

The International Taxation Project
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sirs

**Submission on Review of International Taxation Arrangements**

**Introduction**

The Insurance Council of Australia ("ICA") welcomes the consultative process in relation to the review of certain aspects of Australia's international tax arrangements. In this submission, we have briefly commented on a number of issues, however we note that where there are issues of a general nature, that these have been addressed by a number of other organisations.

The Insurance Council of Australia is the representative body of the general insurance industry in Australia. ICA members account for over 90 per cent of total premium income written by private sector general insurers.

ICA members, both insurance and reinsurance companies, are a significant part of the financial services system. Recently published statistics from the Australian Prudential Regulation Authority (APRA) show that the private sector insurance industry generates direct premium revenue of $ 17.8 billion per annum and has assets of $63 billion. The industry employs about 25,000 people.

ICA members issue some 37.7 million insurance policies annually and deal with four million claims each year.

A number of ICA members have insurance operations that encompass offshore operations. The interaction of Australian tax laws can in some circumstances, have a significant impact on the efficient deployment of capital to increase their business activities. However, a number of taxation provisions do not assist in this process, two of which are specifically addressed below.

## Chapter 2: Attracting equity capital for offshore expansion

We note that the paper focuses on the apparent bias of the imputation system in respect of taxation levied in overseas jurisdictions and the impact that this has on shareholders.

We recognise that this is an impediment to the investment in these companies and in the context of attracting shareholder capital provides a significant disincentive. In addition, the raising of capital by the insurance industry has also occurred as a result of the demise of HIH and the resultant increased capital requirements by APRA.

We would like to highlight to the Board that there appears to be no consideration in the proposal to the implications that the raising of additional capital may have on the tax profile of a corporate group.

Where a company group has losses at the time of entry into consolidation, the recovery of these losses is established by the calculation of a loss factor. However, where a corporate group has increased its capital base, by the issue of shares or the raising of any equity based finance, then the immediate availability of the losses is reduced, which is as a result of the reduction of the loss factor. This increases the tax payable by the company. For the insurance industry, it is only just emerging from a sustained period of low profitability, which was significantly affected by the impact of the September 11 attacks and the collapse of HIH.

Therefore, we are of the view that the two proposals would appear to be mutually exclusive. The benefit of attracting additional capital into Australia will be offset by the additional tax burden that may arise through the restriction of the use of the losses. This burden will exist while ever a consolidated group has losses existing from the time prior to consolidation.

We would therefore recommend that consideration be given to exempting capital injections from the recalculation of the loss factors under consolidation especially where that recapitalisation is required by statutory authorities like APRA. This matter has also been raised with the ATO as part of the consultation on the consolidation legislation.

## Chapter 3: Promoting Australia as a location for internationally focussed companies

### The controlled foreign companies rules (“CFC”)

At the outset, we would note that 12 years after the law has been introduced, there are still a number of anomalies that have not been addressed. Whilst the review is acknowledged, it is not clear as to whether the process will result in the comprehensive addressing of all of the issues that may be raised.

In particular, the ATO and Treasury have been aware for many years of a range of problems with the CFC rules. In many instances these have been raised at the NTLG FSI subcommittee meetings. Sadly, a majority of these matters have failed to progress to a satisfactory resolution.

Australia's CFC regime is amongst the most complex in the world. Given the challenges that Australian insurance companies face in competing with, for example, US or European-based multinationals, they can be affected by the operation of the CFC laws. One clear example of this is in the operation of Section 446(4) of the 1936 Act.

Section 446(4) of the 1936 Act is intended to act as a savings provision for the purposes of allowing general insurance CFC's a concession in respect of the investment income that would be derived in the course of their insurance business. This concession recognised that the investment of premium funds in order to pay claims at a later point of time, was an integral part of the insurance business.

Therefore the original provisions treated "passive" income as "active" for the purposes of determining CFC attribution. Where the company dealt with related parties, the concession was appropriately removed.

Amendments were made to this provision in 1999 to correct a perceived deficiency, in that the provisions allowed for surplus capital to be invested in the CFC, with the result that an inappropriate shelter from tax was achieved on the earnings from the surplus capital. A similar provision, section 446(2) applies for the life insurance industry and gives rise to similar issues.

The explanatory memorandum accompanying the legislation set out the rationale for the amendments. It stated that:

> *"The deficiency in each existing formula is that it excludes passive income derived from assets that are held by the CFC which are in excess of those needed to meet the calculated liabilities of policy holders of life assurance CFCs, or those needed to be set aside to meet outstanding claims of general insurance CFCs. The problem with each existing formula is that if none of the policies give rise to tainted income (that is all the policies are held by unrelated non-residents) there are no tainted calculated liabilities (in subsection 446(2)) and no tainted outstanding claims (subsection 446(4)). Where this is the case, the numerator of each formula is zero and the result is there is no passive income, even if the company has derived passive income on assets in excess of those referable to insurance policies."*

To achieve the required outcome, a series of complex calculations were required to be undertaken, including the calculation of a solvency amount and other potential insurance exposures to determine the level of assets that could be determined as being held to support the insurance liabilities. In addition, the claims reserves need to be calculated on an Australian basis, which imposes a high level of compliance costs in undertaking the calculation.

Whilst we recognise the role of legislation in preventing potential abuse of the law, the way in which the provisions have been implemented has not recognised the requirement of an insurance company (both life and general) to hold capital in a jurisdiction to allow it to expand business or merely to provide additional capital in the event of a slump in the investment markets.

Indeed, since the introduction of the amendments, we are not aware that there has been any attribution from the application of the amended formula. The issue as to how much capital is held in a foreign subsidiary is one that, for commercial purposes, is usually limited to the amount required by the foreign regulator for solvency purposes.

Therefore, we are of the view that the provision, whilst intended to prevent possible abuse, has merely resulted in a significant compliance burden. The requirement to perform complex calculations to ensure compliance with the calculation with continual monitoring of the level of investment income, has merely increased compliance costs with no additional increase to the Revenue.

Whilst it may be said that if there has been no increase in revenue, then the legislation has achieved its objective, it is our view that there would have been no appreciable leakage of revenue under the old system. We would therefore recommend that the provision be amended, to achieve its objective in a simpler and more equitable manner.

**Conclusion**

The above two matters are of significant concern to the industry and have been addressed to highlight the matters. Should you have any questions in relation to this submission please feel free to contact me on 9235 5135.

Yours faithfully

Peter Anderson
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