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1 March 2011

The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

Email: economics.sen@aph.gov.au

Dear Sir

Schedule 2 of the Tax Laws Amendment (2010 Measures No. 5) Bill 2010: Capital Protected Borrowings

The Tax Institute refers to Schedule 2 of the *Tax Laws Amendment (2010 Measures No. 5) Bill 2010* (the **Bill**), and the terms of reference for the inquiry of the Senate Economics Committee (the **Committee**). The Institute welcomes the opportunity to make this submission to the Committee.

The Tax Institute supports an equitable and efficient tax system. To this end, we support tax laws that do not distort investment decisions and do not create unnecessarily burdensome compliance costs. In relation to the Bill, the Institute submits that any amendment to Division 247 should be made with the objective of achieving these two outcomes, and should align with the original objective and purpose of the provisions.

Summary of Submissions:

The approach taken in amending Division 247 should align with the original purpose of the provisions. In particular, the approach should be to apply a rate that is appropriate to determine an amount that approximates the cost to the borrower of separately acquiring capital protection. The approach in the Bill does not appear to align with this purpose and appears to be directed rather at determining a cap on a deductible amount based on costs to the lender of providing the loan. This does not align with the policy of the provision and will likely distort investment decisions.

The Tax Institute is not qualified to make a submission on the appropriate rate to apply for this purpose. However, we submit that account be taken of the views of those best placed to determine the appropriate rate, being the issuers of capital protected products.

Consideration should be given to the compliance costs for borrowers resulting from the proposed change, particularly if this change evidences a diversion from the original policy intent of the provisions.

Purpose of the provisions, equitable tax treatment and distortion of investment decisions

The Explanatory Memorandum to the Bill (**EM**) provides:

> "2.10 The RBA's Indicator Lending Rate for Standard Variable Housing Loans plus 100 basis points is considered to more appropriately reflect the credit risk borne by lenders in capital protected borrowings.
>
> ....
>
> 2.13 The 'adjusted loan rate' achieves a better allocation of the cost of capital protection and the interest expense of a capital protected borrowing borrower as it better reflects both the credit risk (including credit risks for the cost of capital protection that is paid on a deferred basis) and the administration costs of the issuer of a capital protected borrowing.
>
> 2.14 The credit risk borne by the issuer of capital protected borrowings is considered to be more aligned with housing loans rather than personal unsecured loans. The addition of 100 basis points is to reflect the typically relatively small additional credit risk of the issuer for the cost of capital protection that is paid on a deferred basis."

The Tax Institute submits that the correctness of these statement be questioned and examined critically. In particular, the Institute submits that account be taken of submissions made by those entities best placed to determine the risks associated with capital protected lending, being the issuers of those products. The determination of those risks must be made on the basis of real and practical factors and not mere theoretical models.

The Tax Institute also submits that the correctness of this approach to setting the benchmark rate be questioned.

The objective and purpose of the capital protected borrowing provisions is to align the treatment of capital protected borrowings with arrangements under which a borrower borrowed on full recourse terms and separately acquired capital protection. The purpose of the provisions is to deny a deduction for that portion of the limited recourse borrower's costs that approximate the alternative explicit capital protection cost, such that the limited recourse borrower is not treated advantageously.[1] It is not the purpose of the provisions to disadvantage limited recourse borrowers as compared with borrowers under alternative funding arrangements.

Prior to its initial introduction, significant industry consultation was conducted to determine the appropriate proxy rate to apply for this purpose. At that point in time, this was determined to be the RBA indicator rate for personal unsecured loans.

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[1] The position under the law prior to the introduction of Division 247, and the issue Division 247 was intended to address, is set out in paragraph 7.6 of the Explanatory Memorandum to the *Tax Laws Amendment (2006 Measures No. 7) Bill 2006* which provides:

> "The decision in *Firth's case* allows a borrower a more favourable tax treatment for a CPB that does not have a separately identifiable capital protection feature relative to a CPB that has a separately identifiable capital protection feature that is, it allows borrowers to obtain an income tax deduction for what may be in substance a capital cost (being the cost of the put option implicit in limited recourse loans). This different tax treatment based on form, not substance, may distort investment decisions."

The Tax Institute submits that, in altering the rate, the purpose and approach set out above should remain unchanged. That is, the purpose of the provision is to deny a deduction for the amount that is comparable to the cost of acquiring separate and explicit protection. The rate chosen should be the rate most appropriate to determine that cost.

However, the approach set out in the EM appears to be the reverse. That is, the EM appears to set out an approach intended to limit a borrower's deductions to an amount reflecting the issuer's cost of funds and assumed credit risk. This appears to be a change to the purpose of the original provisions.

In particular, it appears that this approach will result in borrowers that are subject to the provisions being disadvantaged as compared with borrowers who have separate funding and capital protection arrangements. In particular, it appears that, under the proposed approach, costs incurred by the borrower that are attributable to the issuer's profit margin (for example) would be treated as non-deductible costs of capital protection. This outcome does not align with the intended policy of the provisions.

If the "adjusted loan rate" produces a non-deductible amount that does not approximate or reflect the cost of separately acquiring capital protection the result will be inequitable treatment of taxpayers in similar circumstances. This will distort both funding and protection choices of investors. It may also distort investment choice as a result of more favourable treatment being given to geared real property investment (for example) than to geared equity investment.

The Tax Institute therefore submits that, in altering the benchmark rate, adequate consideration be given to the original purpose and intention of the provisions, and to the rate that will result in the best approximation of the borrowers' capital protection costs. The Institute further submits that consideration also be given to the fact that the approach outlined in the EM, being to limit the borrower's deductions to those determined by reference to the issuer's costs, and treating all other amounts as the cost of capital protection, does not appear to align with this purpose, and to the extent it does not, the provision may produce inequitable and distortive outcomes.

Compliance costs

The Tax Institute submits that the compliance costs for issuers and borrowers be taken into account in the consideration of the Bill. In particular, the Institute supports a simple and efficient tax system. In this respect, the costs to the revenue should be weighed against the compliance costs of those unnecessarily brought within the provisions if the benchmark rate is set at an inappropriate level.

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If you would like further information or assistance in respect of our submission, please contact me on (02) 8223 0011 or Kirsten Fish on (02) 9353 4757.

Yours sincerely

(...)

Peter Murray
President