15 January 2016

Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
Canberra ACT 2600

Via email: economics.reps@aph.gov.au

Dear Committee,

Inquiry into Interest Deductibility

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.

We are pleased to make a submission to the House Standing Committee on Economics' inquiry into interest deductibility (**"the Inquiry"**). Our submission addresses both points included in the Inquiry's Terms of Reference.

Tax Discussion Paper Process

At the outset, we note that our comments below in relation to interest deductibility, both with reference to non-business individual income and the company income tax system, mirror our comments provided to the consultation process on the "Re:Think Tax Discussion Paper," (**"the Tax Discussion Paper"**) released in March 2015. AFMA has actively participated, and continues to participate, in the Tax Discussion Paper process and looks forward to the completion of the process, culminating with the release of the Government's White Paper, during 2016.

The breadth of the Tax Discussion Paper permits a thorough assessment of the matters within the scope of the Inquiry in a holistic manner. Accordingly, the catalyst and timing of the current Inquiry in unclear, given that it is being conducted in the midst of the Tax Discussion Paper process.

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To the extent that the rationale for the Inquiry is to inform the Tax Discussion Paper process, our comments below should be read in light of AFMA's submission to the Tax Discussion Paper, lodged in June 2015.

1. Personal tax system as it applies to non-business income

The first Term of Reference for the Inquiry is to consider:

> "the personal tax system as it applies to individual non-business income, with particular reference to the deductibility of expenditure of individuals in earning assessable income, including but not limited to an examination of comparable jurisdictions such as the United Kingdom and New Zealand."

The deductibility of interest where loan funds are applied to acquire an income producing asset is a fundamental tenet of Australia's tax system and we strongly caution against any amendments that would disturb this principle. In the current environment, the debate around interest deductibility for non-business income tends to focus on negatively-geared investment properties; however it is appropriate to consider that interest deductibility also may extend to interest paid on financing deployed to acquire income producing assets in other asset classes, such as securities and other financial products.

Negative gearing is a product of the architecture of Australia's taxation system, in particular, the deductibility of interest incurred to acquire an asset that produces assessable income and the CGT discount that applies where individuals and complying superannuation entities dispose of an asset that has been held for more than 12 months and the asset is held on capital account. In AFMA's view, any perceptions that the current taxation settings distort the allocation of capital to certain investments should be viewed through the prism of the appropriateness of the CGT discount, as opposed to the deductibility of interest.

Deductibility of interest incurred to acquire securities and other financial products has been a significant issue for AFMA members, as issuers of such products, since the advent of the "Capital Protected Borrowing" rules, as set out in Division 247 of the *Income Tax Assessment Act 1997* (**the 1997 Act**). This Division acts to split a loan incurred to acquire an income producing asset into two artificial components, namely an underlying loan and a deemed put option, where the loan has an element of capital protection.

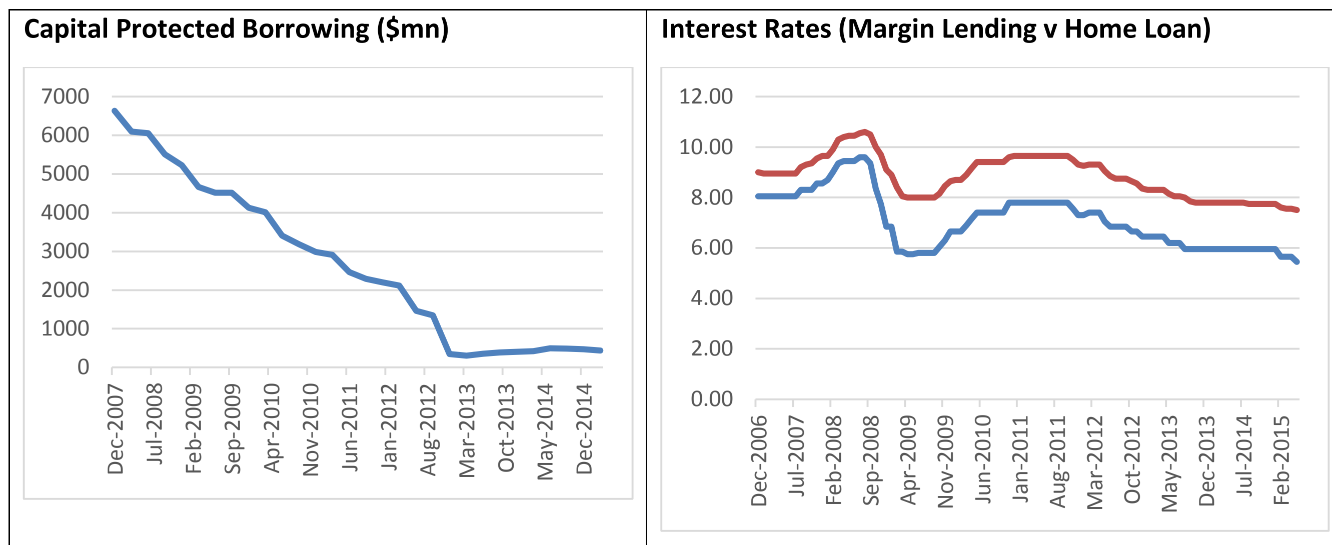
The mechanics of the provisions operate to limit the deductible interest to a benchmark rate of the indicator home loan rate plus 100 basis points. AFMA has maintained that this rate is not a fair reflection of the borrowing costs for investors and stymies the market's ability to meet investors demands for capital protection, especially at times when market volatility would suggest that such protection would be prudent.

Table 1 set out below highlights the inefficiencies associated with the implementation of the benchmark rate, 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 2014 exhibiting a reduction of approximately 80% from the peak (December 2007); and

Price - Non-deductibility 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 85-90bps) and 2015 (spread of approximately 185-210 bps). *(Source – Reserve Bank of Australia Tables F5 and D10)*



The practical effects of these provisions are that investors have higher compliance costs and additional tax obligations in respect of capital protected investments, which may influence decision making and lead to investments based on taxation factors. This is counter-intuitive from an investor-protection policy perspective.

Accordingly, our recommendation would be that deductibility of interest incurred to acquire an income producing asset is maintained, and further that the capital protected borrowing rules be re-evaluated so as to strike an appropriate balance between the costs incurred by investors that are actually referable to the economic costs of acquiring capital protection, to remove any bias that currently exists with respect to such products. AFMA has previously recommended that, at a minimum, the Margin Lending Rate published by the RBA is an appropriate rate.

2. Company income tax system and deductibility of interest incurred by businesses

Similarly, AFMA would caution against any perception of broadening the corporate tax base through further denial of interest deductions on debt incurred by Australian companies. As noted in the recent UK Treasury consultation document in relation to corporate interest deductibility, "(m)ost OECD countries allow interest expense to be deducted in calculating taxable business profit while having rules to protect their tax base from excessive or tax driven interest deductions." Australia fits squarely within that description, with the thin capitalisation rules contained in Division 820 of the 1997 Act

providing an effective fetter against excessive interest deductions being claimed in Australia, especially after their recent tightening.

Action 4 of the OECD's Base Erosion and Profit Shifting (BEPS) Project, titled "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments," sets out a number of best practice options to ensure that interest deductions are not used as a means to engage in profit shifting activities. The conclusion of the OECD Final Report into Action 4 is not that interest should be denied from a deductibility perspective, but rather that restrictions be placed on the extent to which interest is deducted. Such limitations may be based on EBITDA, which is the preferred option of the OECD, or on the level of gearing reflected in the company's balance sheet, as per Australia's thin capitalisation provisions.

Importantly, the recommendations of the OECD acknowledged the special circumstances for banks, many of whom are AFMA members. Given the core business of banking i.e. financial intermediation, any measure that disturbs the deductibility of interest beyond the current regime, which seeks to align the level of capital held on the bank's balance sheet to prudential regulatory requirements, would significantly impact the ability of banks to provide financing to Australian business. Accordingly, the OECD has yet to issue "suitable and specific rules" regarding interest deductibility for banks and insurance companies.

AFMA's view is that the current system, where interest is *prima facie* deductible but restricted to the level of gearing of the taxpayer (as determined with reference to the thin capitalisation provisions in Division 820) and, in the international related party context, is at arm's length (as determined with reference to the transfer pricing provisions in Division 815) strikes an appropriate balance between maintaining Australia's attractiveness as a destination for capital and investment and mitigating risks of profit shifting. Accordingly, AFMA would not recommend any shift away from the current settings, especially in the midst of the Tax Discussion Paper process.

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AFMA appreciates the opportunity to make a submission to the current Inquiry. Please contact the writer with any queries.

Yours sincerely,

Rob Colquhoun
Director, Policy