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Mr Jason Falinski MP
Chair
House of Representatives Standing Committee on Tax and Revenue
Parliament House
CANBERRA ACT 2600

Dear Mr Falinski

Inquiry into the Development of the Australian Corporate Bond Market

The Inspector-General of Taxation and Taxation Ombudsman (**IGTO**) welcomes the opportunity to contribute to the House of Representatives Standing Committee on Tax and Revenue's (**Committee**) Inquiry into the Development of an Australian Corporate Bond Market.

The IGTO is an independent statutory agency that investigates taxation administration systems and laws, as well as the actions and decisions made by Tax Officials - of the Australian Taxation Office (**ATO**) or the Tax Practitioners Board (**TPB**). The IGTO seeks 'to assure and ensure that there is fair, equitable, and transparent administration of the tax system consistent with community expectations.'[1] We also undertake tax investigations for the purpose of providing independent advice and assurance to Government on the taxation administration laws and systems.

The IGTO is not empowered to investigate or advise on tax policy matters. Accordingly, this submission does not make (or intend to make) comment on the appropriateness of current tax settings as applied to corporate bonds. Rather, we have undertaken some research and set out some observations that may assist the Committee in its consideration of corporate bonds and its interaction with the tax administration system. We trust these comments and observations are of assistance to the Committee with its Inquiry.

We understand the terms of reference for this Inquiry are to examine:

- *the tax treatment of corporate bonds for both issuers and investors to determine whether there are any impediments in the tax system to the issue of corporate bonds compared to other forms of debt financing for business;*
- *related impediments within the Corporations Act to the further development of the corporate bond market, including how they interact with the tax system; and*
- *comparable policy settings in other jurisdictions, with a focus on those jurisdictions that are major sources of debt finance for companies operating in Australia.*

[1] Inspector-General of Taxation and Taxation Ombudsman, *Corporate Plan 2020 – 2023* (2019) p 5 <https://igt.gov.au/accountability-and-reporting/>.

Although investor preferences are likely to be determined by a range of non-tax related factors, the Committee may wish to examine the following tax considerations as part of its Inquiry:

- Whether the Australian tax settings and foreign capital requirements can contribute to circumstances which favour capital bond raisings in foreign markets. That is, because the after-tax return received by resident versus non-resident investors for an Australian issue or foreign issue of corporate bonds can differ;

- Whether tax uncertainty and the availability of administratively binding advice and guidance for investors in corporate bonds is contributing to investor preferences. This may include the following issues:
  - whether the debt versus equity distinction under Australian taxation laws is contributing to investor tax uncertainty; and
  - whether class rulings, public rulings or private rulings are operating appropriately.

We expect that there are other professional advisory firms and/or organisations that may be better placed to assist the Committee with the commercial and market dimensions of the Inquiry. However, to assist the Committee, we have undertaken some preliminary research and made some general observations which are set out below.

Investors and the Corporate Bond Market – some Background Information

1. There are currently a mix of bonds issued by both Australian and international companies in the Australian market. In particular, 'Kangaroo Bonds' (foreign bonds issued in the Australian market by non-Australian firms) represent 'a significant share of the Australian bond market'.[2]

2. In 2018, Deloitte Access Economics released a report on the corporate bond market (**the DAE Report**) which provides some useful information for the Committee's Inquiry. This includes key facts and figures as well as observations that DAE made in relation to their research. We summarise some key points from the DAE Report for the benefit of the Committee:

   a) 47% of the Australian corporate bond market is owned by Australian investors (including individuals, superannuation funds, government and Australian entities);[3]

   b) more than $1 trillion of corporate bonds were outstanding in 2017;[4]

   c) the corporate bond market is 'more than two-thirds the size of the Australian stock market (**ASX**)';[5]

   d) '95% of Australian corporate bonds are issued almost entirely to wholesale investors'; however, a small portion of corporate bonds are offered to retail investors and quoted on the ASX.[6]

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[2] Michelle Bergmann and Anna Nitschke, *Kangaroo Bond Market* (September 2016) <https://www.rba.gov.au/publications/bulletin/2016/sep/pdf/rba-bulletin-2016-09-the-kangaroo-bond-market.pdf>.

[3] Deloitte Access Economics, *The Australian Corporate Bond Report 2018* (2018) p 2 <https://www2.deloitte.com/content/dam/Deloitte/au/Documents/Economics/deloitte-au-economics-corporate-bond-report-2018-030518.pdf>.

[4] Ibid.

[5] Ibid.

[6] Ibid 21. Bonds offered to retail investors and quoted on the ASX have reduced prospectus and disclosure requirements, as permitted by the *Corporations Amendment (Simple Corporate Bonds and Other Measures) Act 2014* (Cth).

e) ‘Bond investment by private individuals has historically been relatively low, because most bonds are traded in the professional market (‘over the counter’) and in large parcels of $500,000 or more’;[7]

f) ‘16% of High Net Worth Individuals (**HNWI**) in Australia have direct holdings of corporate bonds.’[8] A majority of these individual investors are older Australians, with corporate bonds consisting of ‘22% of assets for individuals aged 55 and over, compared to 3 - 4% for investors in younger age groups’.[9]

g) This is due to the nature of corporate bonds and returns received being more suited to private investors transitioning into retirement, with an ageing population supporting the demand for corporate bonds.[10] However, the DAE Report notes that bonds consist of less than 1% of Australian private investors’ investment portfolios, in comparison to 19% in the United States.[11]

h) Of the private investors who hold corporate bonds, 26% buy and hold these until maturity.[12] This is in comparison to 13% who actively trade bonds.[13] The remainder adopt a mix of strategies depending on the market environment.[14]

3. The DAE Report observes that, in 2016, bonds comprised less than 10% of Australian superannuation fund investment portfolios - less than the Organisation for Economic Co-operation and Development (**OECD**) average of 40%.[15]

4. We refer the Committee to Chart 19 of the DAE Report for the OECD countries’ pension fund asset allocations in bonds and bills for 2016.

5. The DAE Report noted that low levels of bond holdings are particularly evident in Self-managed Superannuation Funds (**SMSF**) which had 1% of assets held in debt securities in 2017.[16] It has been noted that the lack of superannuation fund investment in corporate bonds may be due to the ‘lack of depth and relatively low liquidity of the domestic market’.[17]

6. We refer the Committee to Chart 3 of the DAE Report for a further breakdown of the ownership share of outstanding Australian corporate bonds in June 2017.

7. The DAE Report considered the reasons why investors may choose to hold corporate bonds, with a key reason being access to a reliable income stream from regular coupons paid by corporate bonds (73%).[18] The DAE Report also noted that 72% of investors felt that corporate

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[7] Ibid 6.
[8] Ibid 21.
[9] Ibid 6.
[10] Ibid 14.
[11] Ibid 44.
[12] Ibid 26.
[13] Ibid.
[14] Ibid.
[15] Ibid 44.
[16] Ibid 21.
[17] James Darcy, *Insight: Development of the Corporate Bond Market* (8 July 2014) <https://www.allens.com.au/insights-news/insights/2014/07/unravelled-development-of-the-corporate-bond-market/>.
[18] Above n 3, 30.

bonds 'offered good overall return given their risk profile'.[19] Corporate bonds diversify the investor's investment portfolio, with corporate bonds offering a mid-point between other lower-return and lower-risk fixed income investments and high-return but riskier shares.[20]

8. The Committee may wish to refer to Chart 12 of the DAE Report for further information on the reasons for corporate bond investment.

9. For HNWIs, in particular, the DAE Report found that almost 70% of those without corporate bond holdings have insufficient understanding to feel comfortable investing in corporate bonds.[21] Additionally, 20% of non-investors perceive corporate bond fees and costs as being too high.[22] The DAE Report noted that non-investors perceived corporate bonds as not being a tax-effective investment.[23]

Tax Treatment for Different Types of Taxpayers

10. In relation to the investor's perceptions about taxation laws and corporate bonds, the DAE Report noted that:

> *…more than 40% of Australian HNWIs surveyed highlighted uncertainty in the government's taxation and superannuation policy as a current concern around their investments. Corporate bonds do not receive the tax benefits that some other investments receive, such as dividend imputation for shares or the possibility of negative gearing for investment properties. Indeed, some 14% of private investors without corporate bond holdings cited this lack of tax effectiveness as a barrier to investment.*[24]

11. Furthermore, the DAE Report argued that:

> *However, this also means that there is lower political risk associated with corporate bond investments. For example, any future changes to franking credits under the dividend imputation system could affect returns earned on share investments, but bond investments would be unaffected as they currently do not receive special tax treatment.*[25]

12. The DAE Report indicated that this serves as a potential barrier for prospective investors looking to invest in corporate bonds, as there does not appear to be tax incentives or concessions encouraging investment.[26]

13. However, as we note below there are some existing interest withholding tax exemptions for non-resident investors and we have also observed that there are differing views on the impact of taxation laws on corporate bonds. Another report drafted by the Australian Centre for Financial Studies (**ACFS**) noted that:

> *One potential reason for relatively limited development of the corporate bond market might thus be found in a low appetite for use of debt finance by Australian companies.*

[19] Ibid.
[20] Ibid 31.
[21] Ibid 36.
[22] Ibid 35.
[23] Ibid 42.
[24] Ibid.
[25] Ibid.
[26] Ibid.

Compared to overseas countries, this could occur because the Australian taxation system significantly reduces the incentive for Australian companies to use debt rather than equity finance. The 'classical' tax system common overseas provides an incentive for firms to take on leverage because interest paid can be expensed against taxable income while dividend income is taxed twice, once at the company level and once in the hands of the investor. In contrast, the dividend imputation system used in Australia taxes all forms of capital only once in the hands of the investor. This means that unlike in countries that operate under a classical tax system, there is no (or little) advantage from a tax perspective for companies to issue debt over equity.[27]

14. Some other tax consequences for investors include:

    a) Tax implications and consequences from proceeds (gains or losses) made from the disposal of corporate bonds may vary depending on individual circumstances and the type of investor.

    b) For instance, individuals will pay tax at their marginal rates;[28] whereas entities that meet the conditions outlined in section 23AA of *Income Tax Rates Act 1986* (Cth) are taxed at the lower corporate tax rate of 27.5%.[29] All other companies are taxed at 30%.[30] Superannuation funds, on the other hand, pay 15% tax for assets in the accumulation phase and 0% for pension assets.[31]

    c) The profit from the redemption of corporate bonds is generally treated as 'other income' and not treated as a concessionally taxed capital gains.[32]

    d) Conversely, where there a loss is made on redemption, a 'revenue' deduction can be claimed and no capital loss recognised.[33]

    e) The ATO has stated that interest received by corporate bond holders is generally included as 'gross interest' and treated as assessable income.[34]

15. Non-residents are generally subject to a final 10% interest withholding tax subject to the terms of any relevant double tax agreement and any specific exemptions provided under domestic laws.[35]

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[27] Australian Centre for Financial Studies, *Australian Debt Securities and Corporate Bonds* (2014) p 10 <https://business.nab.com.au/wp-content/uploads/2014/02/australian-debt-securities-and-corporate-bonds-february-2014.pdf>.
[28] Australian Taxation Office, *Individual income tax rates* (27 June 2019) <https://www.ato.gov.au/Rates/Individual-income-tax-rates/>.
[29] Australian Taxation Office, *Draft Law Companion Ruling LCR 2018/D7: Base rate entities and base rate entity passive income* (2018) <https://www.ato.gov.au/law/view/pdf/pbr/lcr2018-d007.pdf>.
[30] Australian Taxation Office, *Company Tax Rates* (14 August 2019) <https://www.ato.gov.au/Rates/Company-tax/>.
[31] Australian Taxation Office, *Tax Exemptions in the Retirement Phase* (15 August 2018) <https://www.ato.gov.au/Super/Self-managed-super-funds/Investing/Tax-on-income/Tax-exemptions-in-the-retirement-phase/>.
[32] Australian Taxation Office, *Sale or Disposal of Company Bonds and Convertible Notes* (30 May 2019) <https://www.ato.gov.au/Forms/You-and-your-shares-2019/?page=25>.
[33] Ibid.
[34] Ibid.
[35] Australian Taxation Office, *Interest, Unfranked Dividends and Royalties* (31 May 2019) <https://www.ato.gov.au/Individuals/International-tax-for-individuals/Investing-in-Australia/Interest,-unfranked-dividends-and-royalties/>.

16. For example, Australian companies may be exempt from interest withholding tax on interest paid to foreign residents if they satisfy the 'public offer' conditions outlined in section 128F of *Income Tax Assessment Act 1936* (Cth). The 'public offer test' requires a syndicated loan or debentures to be offered in one of five ways:

    a) to at least 10 unrelated entities that are in the business of providing finance, or investing or dealing in securities, in the course of operating in financial markets;

    b) to at least 100 investors who have acquired such interests in the past, or would be likely to be interested in acquiring such interests;

    c) as a result of being listed on a stock exchange;

    d) as a result of negotiations being initiated publicly in electronic form (e.g. on Reuters or Bloomberg) or in another form used by financial markets for dealing in debentures or relevant debt interests (such as through distribution of an information memorandum); or

    e) to a dealer, manager or underwriter who agrees with the issuer to offer the debenture or relevant debt interest for sale within 30 days of having an unconditional obligation to do so in a manner described in 16 a) to e).[36]

17. We note that this exemption also applies to unit trusts.[37]

18. We observe that this can give rise to the differential tax treatment between resident and non-resident taxpayers, despite their investment in the same corporate bonds. Accordingly the investor profile permits potentially higher after-tax returns for non-resident investors (but this ignores any non-resident tax to be paid).

19. Furthermore, the tax consequences may also depend on the nature of the corporate bond. It was noted above that the disposal of a corporate bond does not generally attract a capital gain or loss. However, if the corporate bond converts to shares, then the Capital Gains Tax (**CGT**) provisions may apply upon disposal of the converted shares.[38] We note that the tax consequences for one investor of corporate bonds could be completely different to another depending on a number of factors, including those discussed earlier.

ATO Guidance

20. Australia has operated a self-assessment system since 1986-87. The need for the ATO to provide greater tax certainty in the form of public and private rulings was recognised in the early 1990s. Such rulings are legally binding on the ATO and accordingly provide taxpayers with certainty of the tax treatment that will be adopted by the ATO.

[36] Ian Kellock and Bronwyn Kirkwood, 'Practical Issues for Interest Withholding Tax and Section 128F' (Conference Paper, 2018 Financial Services Taxation Conference, February 2018) p 9 <https://tticdn.blob.core.windows.net/tti-files/dmfile/practical-issues-for-interest-withholding-tax-paper.pdf>.
[37] *Income Tax Assessment Act 1936* (Cth) s 128FA.
[38] Australian Taxation Office, *Convertible Notes* (28 June 2019) <https://www.ato.gov.au/General/Capital-gains-tax/Shares,-units-and-similar-investments/Convertible-notes/>.

21. We observe that the number of binding and non-binding advice issued by the ATO has declined from 2009 to 2019. This is consistent across the different types of advice products offered.[39] Concerns about this decline have been raised with the IGTO by practitioners and publicly by the Tax Institute, where it identified a trend for the ATO to move away from providing advice.[40]

22. On the specific subject of corporate bonds, our search on the ATO's Legal Database shows that the most recent ATO Public Guidance products on corporate bonds were released in 2017. There were also four private binding rulings issued by the ATO in 2018, 2019 and 2020. A list of the products from the last five years is set out in the table below:

Year	Product Type	Title
2016	Class Ruling	*CR 2016/1 - Class Income tax: loans from Public and Private Ancillary Funds to AUSiMED Limited*
2017	Practical Compliance Guideline	*PCG 2017/4 - Practical compliance guidelines ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions*
2018	Private Binding Ruling	*1051449059368 - Non-arm's length income*
2019	Private Binding Ruling	*1051499583593 - Financial institutions for the purposes of the Australia and the Relevant taxation convention*
2020	Private Binding Ruling	*1051624851288 - Withholding tax - interest and dividends - Double Tax Convention*
2020	Private Binding Ruling	*1051618679754 - Withholding tax - superannuation fund for foreign residents*

23. Depending on the nature of the bond, it can be classified as either a debt or equity interest for Australian taxation purposes. However, the relevant classification for tax purposes can be difficult to make in some circumstances and need not align with accounting or market classifications. That is, the debt versus equity divide is not strictly a bright line test for all purposes.

24. ASX Guidance Note 34 attempts to provide some assistance in identifying how to classify the corporate bond but it does not apply to bonds traded off-market (where the majority of bonds are being traded).[41] Additionally, rules for determining what is equity or debt for tax purposes are contained in Division 974 of the *Income Tax Assessment Act 1997* (Cth). Due to the complexities in this area, taxpayers are likely to seek comfort in obtaining and relying upon binding ATO Advice such as public and private rulings.[42]

25. At this stage, our office has not received any complaints related to corporate bonds.

26. We observe that the lack of binding advice on corporate bonds may mean that the tax treatment is sufficiently certain and taxpayers do not require additional ATO guidance in this area. Alternatively, it may be due to low levels of corporate bond investments in the Australian market. The Committee may wish to explore whether additional ATO guidance on aspects of

[39] Professor Richard Vann and Andrew Hirst, 'Rulings Update' (Conference Paper, 2020 Financial Services Taxation Conference, February 2020) p 14.
[40] The Tax Institute, *ATO Guidance* (14 November 2019) <https://tticdn.blob.core.windows.net/tti-files/dmfile/tax-institute-submission---ato-guidance-.pdf>.
[41] Australian Stock Exchange, *ASX Listing Rule Guidance Note 34: Naming Conventions for Debt and Hybrid Securities* (1 December 2019) <https://www.asx.com.au/documents/rules/gn34_debt_and_hybrid_securities.pdf>.
[42] Australian Bankers' Association Inc., *Review of the Debt and Equity Rules Submission* (May 2014) <http://taxboard.gov.au/files/2015/07/ABA.pdf>.

corporate bond investments is warranted and would additional guidance provide more certainty and clarity for investors. That is, whether this would enhance the regulatory regime for corporate debt to facilitate a deeper and more active retail corporate bond market.

The IGTO thanks the Committee again for the opportunity to make this submission. If we may be of any further assistance to the Committee, please don't hesitate to contact me [redacted]

Kind regards,

[redacted]

Karen Payne
Inspector-General of Taxation and Taxation Ombudsman

APPENDIX 1

Relevant/ Useful Resources
Further to our submission, the Committee may find the following information relevant:

- Australian Centre for Financial Studies, *Australian Debt Securities and Corporate Bonds* (2014) <https://business.nab.com.au/wp-content/uploads/2014/02/australian-debt-securities-and-corporate-bonds-february-2014.pdf>.

- Darcy, James, *Insight: Development of the Corporate Bond Market* (8 July 2014) <https://www.allens.com.au/insights-news/insights/2014/07/unravelled-development-of-the-corporate-bond-market/>.

- Deloitte Access Economics, *The Australian Corporate Bond Report 2018* (2018) <https://www2.deloitte.com/content/dam/Deloitte/au/Documents/Economics/deloitte-au-economics-corporate-bond-report-2018-030518.pdf>.