



THE UNIVERSITY OF
SYDNEY

Dr Shumi Akhtar
Associate Professor
The University of Sydney

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To: The Hon Josh Frydenberg MP (Treasurer) and Mr Jason Falinski MP (Chair)

The Senate House of Representatives Standing Committee on Tax and Revenue
PO Box 6021
Parliament House
CANBERRA
Canberra ACT 2600

Phone: [+61 2 6277 4821](tel:+61262774821)
Fax: 02 6277 2221
Email: TaxRev.reps@aph.gov.au

RE: Inquiry into the Development of the Australian Corporate Bond Market

I, Shumi Akhtar (Associate Professor at the University of Sydney Business School), would like to express my gratitude to the Senate House of Representatives Standing Committee on Tax and Revenue for the opportunity to make this submission on the inquiry into the development of the Australian Corporate Bond Market.

Firstly, I would like to affirm Senator Gerard Rennick's assertion: "Australian lenders are subject to the full corporate tax rates on their interest margin. On the other hand, offshore lenders who issue a corporate bond, subject to certain conditions are not subject to any withholding tax in Australia because they can receive an exemption under s128F of the Income Tax Assessment Act." To understand the Australian corporate debt market and a possible revision of the tax implications arising from corporate bond issuance, it is first necessary to obtain a data-driven insight to gauge the depth and breadth of the Australian corporate debt (including bond) market. I address the following terms of reference in the inquiry into the development of the Australian Corporate Bond Market:

- *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*
- *comparable policy settings in other jurisdictions, with a focus on those jurisdictions that are major sources of debt finance for companies operating in Australia.*



INSIGHTS INTO AUSTRALIAN DEBT ISSUANCE ACTIVITIES

Most active bond-issuing sectors in Australia – In a sample of 100,551 Corporate Bond issuance data points that are available from 1986 to mid-2020 (Table 1), Banking and Financial sector corporates issued the highest number of corporate bonds (84,701) followed by corporates in the Financial (Others) sector (10,511), Conglomerate/Diversified Manufacturing sector (10,511), Securities sector (934) and Telecommunications sector (603). Although Australia’s corporate landscape is dominated by Metals/Mining businesses, interestingly these corporates have issued very few bonds (289) during the past 35 years. Corporates in the Airline, Retail and Industrial sector rarely issue corporate bonds while corporate bond issues by the Electronics, Health Care Supply and Pharmaceuticals in Australia is almost non-existent.

Corporate Debt Instrument Ratings and Corporate Ratings in Australia – Figure 1a shows that the vast majority of corporate debt instruments issued in Australia are AA- rated by Standard and Poor (S&P) followed by A and AA. The debt instrument ratings are closely-aligned to the debt rating of the issuer, which is depicted in Figure 1b.

Types of Debt Instruments in Australia – Australian corporations utilise a variety of debt instruments. Figure 2 shows that the majority of debt instruments used in the Australian market are Certificate of Deposits, Commercial Papers and Notes that are short term in nature (having duration of less than 12 months). Corporate bond issuances are comparative low (581 times over 35 years) for the given sample. The lead underwriters of debt instrument issuances are mainly international banks, including Deutsche Bank, HSBC, Barclays and Citigroup.

Currency used in Australian Debt Instrument Issuances– The majority of Australian debt instruments are denominated in Australian Dollars followed by US Dollars, Japanese Yen, British Pounds and Hong Kong Dollars.

Market and Countries of Issuance – Australian corporations issue approximately 40% of their debt in the local/domestic market (in Australia) and 60% in foreign/non-domestic markets. Among the most popular types of foreign bonds issued by Australian corporates are Eurobonds, Yankee Bonds, Dim Sum Bonds, Global Bonds, Uridashi Eurobonds, Samurai Bonds, Kauri Bonds and Maple Bonds. The main countries for debt security issuances are mainly overseas (United States, Switzerland, UK and Japan) and Australia.

Investment Grade – Of the 100,551 debt instruments that have been issued from 1986 to mid-2020, only 8% of the data had investment grading information. Out of the available data, 99% of the debt issuances was investment grade and the rest High Yield.

Tenor of Australian Corporation Debt Issues – Bills (short term debt) are the most popular type of corporate debt. For long term issues, 5-year debt securities are the most popular followed by 10-year, 3-year, 2-year and 30-year bonds. Only a very small proportion of debt (less than 0.02%) is issued as green-debt or bonds.

Amounts Issued – Over the last 35 years, the total debt issued by Australian corporates was approximately U\$4.75tn. Out of this total, U\$118.38bn was labelled as bond-type debt securities. Figure 3a and Figure 3b show the value and frequency of corporate bond issuance



in Australia across the years. The value of corporate bond issues peaked in 1999 and in 2008, while the highest number of bond issuances occurred in 2009.

TAX TREATMENT OF CORPORATE DEBT

The tax treatment of corporate bond transactions affects both the issuer of the bond (seller) and the investor in the bond (buyer). There are a number of factors that affect bond issuances - terms of issuance (particularly important for primary versus secondary market trades, callable, convertible, asset backed, secure/unsecure etc.), size of issuance amount, maturity date, credit quality, the cost of issuing bonds (transaction cost), bond service or coupon payment (eg. interest payment to the investor) and the purpose of the proceeds. Transaction costs (eg. underwriter fees, management fees, broker fees, legal fees) for bonds can be higher than its counterpart, equity issuances. This additional cost is primarily due to a lack of bond price transparency which directly relates to bond liquidity (frequency of transactions) and information availability. Since the Australian corporate debt market is relatively inactive, transaction costs for debt issuances are most likely to be higher and this is just one of the many reasons why Australian businesses would be reluctant to raise debt capital locally (on the demand side). An equally important deterrent for Australian investors (on the supply side) investing in Australian corporate debt instruments is because of the differing tax treatment between equity and debt investments. Under Australia's imputation tax system, an Australian investor earning \$100 from an equity investment will enjoy a far more beneficial tax treatment as opposed to a debt investor of the same amount.

As shown in Figure 4a and 4b, the main debt markets used by Australian corporates are the Eurobond market, followed by the US, Switzerland, UK and Japan. In fact, Australian corporations borrow 40% of their debt in Australian dollars and 60% in foreign denominated currencies. This raises an important issue regarding the tax treatment of who holds/buys/invests in Australian corporate debt or bonds. Most Australian debt security holders are foreign investors (non-residents) who are subject to interest withholding tax (IWT) and this may be reduced to 10% under an applicable Double Tax Agreement (DTA).¹ Foreign investors that are financial institutions or government bodies in the US, Japan, UK and Switzerland will not be subject to Australian IWT on interest payments received under the terms of their DTAs. Comparatively speaking an Australian resident earning income from holding Australian corporate debt would be subject to their marginal income tax which is up to 45% (for individuals) and 30% for institutional investors. This is where things get really undone for Australian resident investors because debt investments seemingly do not have concessionary tax treatment – equity investors would be eligible for franking credits while real estate investors would be eligible for negative gearing. In fact, all the debt investment benefits are ripped by the non-resident investors. Although a 10% IWT is common in most jurisdictions and a lower IWT is meant to encourage inflow of foreign capital into Australia, Australian resident lenders are disadvantaged relative to non-resident investors due to the seemingly different tax

¹ For completeness, the foreign investor would still be subject to income tax on the interest income at the rate imposed by their jurisdiction of residence in addition to the Australian IWT levied on the interest income. Under an applicable DTA, where Australian IWT has been paid, a Foreign Tax Credit may be available against their income tax on that interest income



treatment. A more favourable tax treatment of debt income would go a long way towards encouraging local investors and lenders to dive into debt market investments. This is especially critical for our senior investors and retirees. It is acknowledged that DTAs are bilateral in nature so Australian investors would be able to access a reduced IWT for investing in foreign debt – however often these benefits are restricted to sophisticated investors and financial institutions, as opposed to the average Australian pensioner/retiree.

Australian superannuation and pension funds have a value that is at least three times bigger than our GDP – this includes trillions of dollars and yet only a very small portion is invested in the debt market. Investment in debt markets (both government and corporate) is important for diversification. Equity or real-estate or alternative investments are much riskier than investment in government bond or corporate bonds, due to the sheer size and creditworthiness of the corporations. Given the current headwinds facing our economy from the COVID-crisis combined with the Chinese Cold War, it has never been more important that we redesign our tax system for retail and institutional investors to promote Australia as an internationally competitive debt market.

For tax purposes, bonds are not treated any differently to any other types of debt (notes, commercial paper, bills etc) in Australia. Taxation of Financial Arrangement (TOFA) was first introduced as part of the 1992 Federal Budget. Following this, the Ralph Review of Business Taxation was undertaken which made a number of recommendations. These recommendations were progressively introduced in stages:

Stage 1 (2001): Rules of distinguishing between debt and equity interests.

Stage 2 (2003): New rules to bring to account foreign exchange gains and losses and realization of translation of currency conversion (risk).

Stage 3 and 4 (2009): Introduction of the hedging election for TOFA purposes, which governed the tax timing of gains/losses from hedging and financial arrangements.

Figure 5a and 5b depict the reactions of the Australian debt market to the above three stages of tax policy revision/reform. Figure 5 illustrates the corporate sector reaction to each stage of reform, with a significant reaction seemingly observed following the introduction of Stage 3 and 4 reforms (shown in Figure 5a (note: only mid-year is available for 2020, this is not a full reflection of the year)).

INTERNATIONAL COMPARISON OF DEBT MARKETS

On a global scale, corporates/businesses are far more active borrowers relative to governments (Figure 6a). Corporate debt activity has been steadily increasing since the beginning of the 21st century, while Australian corporate debt activity (Figure 6b) noticeably increased beginning 2007 and spiked in 2017 onwards.² Australia's closest debt market competitors are Singapore (Figure 6c) and Hong Kong (Figure 6d) and it is shown that Australia has been lagging these

² This may relate to the law change allowing the ATO to share tax debt information for corporations with credit reporting bureaus during 2016/2017 – whether this had any meaningful effect requires further research (it is outside the scope of this submission).



markets up until the last few years (2017 onwards). A direct comparison of total debt instrument issuance across Australia, Singapore and Hong Kong can be seen in Figure 7a. Australia falls severely short in its corporate bond issuance on offer relative to Singapore (which had three times more corporate bond issuances than Australia) and Hong Kong (double the number of corporate bond issuances compared to Australia). Figure 7b shows a relative cross-year comparison of corporate bond activity across Australia, Singapore and Hong Kong. It can be observed that Australia is well behind in terms of corporate bond issuances over the last decade.

The optimal debt theory concept in Finance sets out the trade-off between the tax advantages from debt raising (interest being tax deductible) versus raising too much debt, pushing a corporation into the risky territory of potential bankruptcy. It is vital that every corporation has a good understanding of the benefits of debt issuance, otherwise the potential risks may outweigh the tax benefits. Figure 7c shows that over the years, Australia's statutory corporate tax rate has been significantly higher than its counterparts in Singapore and Hong Kong. This implies that the debt servicing tax benefit is comparatively higher in Australia than its closest competitors. However, Australian corporate debt issuance activities have been much lower than Singapore and Hong Kong. This evidence implies that Australian corporations may not be utilising their optimal debt capacity (e.g. issuing lesser debt than what they actually should). It may well be that this phenomenon stems back to Australia's relatively less active or liquid debt market.

Out of all corporate debt markets globally, the US corporate bond market is the most active, liquid and transparent in the world. The US has the National Association Securities Dealer (NASD), which requires bond dealers to report all over-the-counter (OTC) bond transactions through a bond pricing reporting system (TRACE (Trade Reporting and Compliance Engine)) which was established mid-2002. Australia does not have such system set-up yet and it is absolutely vital that we have a similar system set up. Only a small portion of Australian corporations actively issue debt and these are mostly financial corporations. Non-financial corporations hardly issue debt. For example, Australian non-financial corporations issued debt equalling one third of what the Australian government issues. This is highly concerning. Figure 8 shows the distribution of the total outstanding debt of US\$1.883tn as of Q42019 among financial, non-financial and government debts. Over the last 35 years, Australian corporations have raised about US\$4.75tn across a variety of debt in which corporate bonds accounted for only US\$118.38bn.

Australian Corporations' Net Debt Levels & Interest Coverage Across Industries

Figure 9 presents Australian corporations' net debt across various industries on an aggregate level. Industry net debt serves as a metric indicating the overall debt situation of a company by netting the value total debt of a company minus cash in hand. The net debt position implies how well a company can pay all of its debts if they were due immediately. Alternatively speaking, net debt indicates how much liquidity a company has to meet its debt obligations. Figure 9 shows that almost every industry in Australia has increased their debt capacity over the years, although the net debt levels for Consumer Staples and Basic Materials have experienced volatility. On a comparative level, the financial industry has been the biggest debt



issuer in Australia over the last two decades, resulting in the highest net debt level across all industries (as shown in Figure 10). Additional to the net debt matrix, Figure 11 and Figure 12 shows the interest coverage capacity (i.e. debt servicing capacity which is measured as earnings before interest and tax over debt interest payments) across industries for the last three decades. Most Australian companies across industries have an interest coverage ratio above 1, indicating they have sufficient earnings buffers to service their debt.

In conclusion, more research is needed with better data accessibility and more grant funding for this very important issue. The Australian government and the ATO are making some good progress but much work (research, revision of tax policy, reformation/restructure of debt markets, greater regulation and transparency, effective law enforcement and amendments in corporate law) is urgently needed if we want to position Australia as a competitive debt market with its major trading partners and investment competitors. I will happily welcome any opportunity to discuss further if required by the Standing Committee of Tax and Revenue. Thank you.

Sincerely,

Shumi

Dr M. SHUMI AKHTAR | Associate Professor
Discipline of Finance | The University of Sydney Business School

THE UNIVERSITY OF SYDNEY
Rm 423, The University of Sydney Business Building (H69) |
Cnr of Codrington Street & Darlington Lane | Camperdown Campus
The University of Sydney | AUSTRALIA | NSW | 2006

 | W <http://sydney.edu.au/business/staff/shumia>



Table 1 (Panel A)
Corporate Bond Issuance Frequency for Australian Corporation over 35 years

Sector	Frequency	Sector	Frequency
Cable/Media	1	Publishing	2
Home Builders	1	Securities	2
Retail Stores - Food/Drug	1	Chemicals	3
Transportation - Other	1	Life Insurance	3
Vehicle Parts	1	Retail Stores - Other	3
Automotive Manufacturer	2	Airline	4
Consumer Products	2	Conglomerate/Diversified Mfg	4
Food Processors	2	Real Estate Investment Trust	5
Gaming	2	Building Products	8
Gas Utility - Local Distrib	2	Oil and Gas	8
Gas Utility - Pipelines	2	Utility - Other	17
Health Care Facilities	2	Service - Other	27
Industrials - Other	2	Telecommunications	37
Leasing	2	Metals/Mining	42
Leisure	2	Financial - Other	149
Property and Casualty Insurance	2	Banking	240

Table 1 (Panel B)
Various Debt Issuance Frequency for Australian Corporation over 35 years

Industry Sectors	Number of Issuance	Industry Sectors	Number of Issuance
Health Care Supply	1	Life Insurance	26
Information/Data Technology	1	Retail Stores - Food/Drug	29
Oilfield Machinery and Services	1	Gas Utility - Pipelines	43
Pharmaceuticals	1	Property and Casualty Insurance	49
Restaurants	1	Oil and Gas	52
Tobacco	1	Gas Utility - Local Distrib	54
Vehicle Parts	1	Building Products	59
Aerospace	2	Airline	77
Containers	3	Beverage/Bottling	87
Electronics	3	Utility - Other	91
Consumer Products	7	Textiles/Apparel/Shoes	92
Home Builders	7	Food Processors	106
Transportation - Other	7	Real Estate Investment Trust	106
Health Care Facilities	8	Leasing	127
Machinery	8	Automotive Manufacturer	134
Gaming	9	Service - Other	211
Railroads	9	Metals/Mining	289
Publishing	10	Telecommunications	603



Leisure	12	Securities	934
Cable/Media	15	Conglomerate/Diversified Mfg	940
Retail Stores - Other	15	Mortgage Banking	1076
Chemicals	16	Financial - Other	10511
Industrials - Other	16	Banking	84701
		Total Issuance	100551

Figure 1 - a

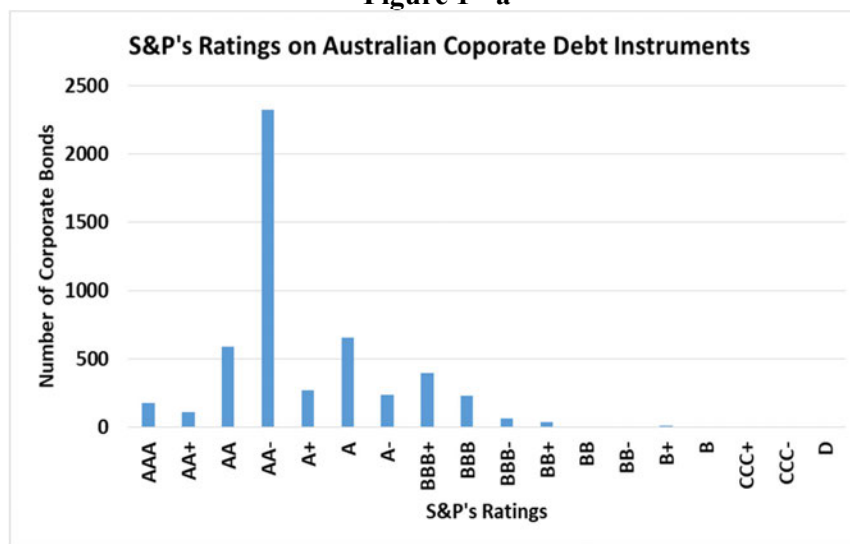


Figure 1 - b





Figure 2

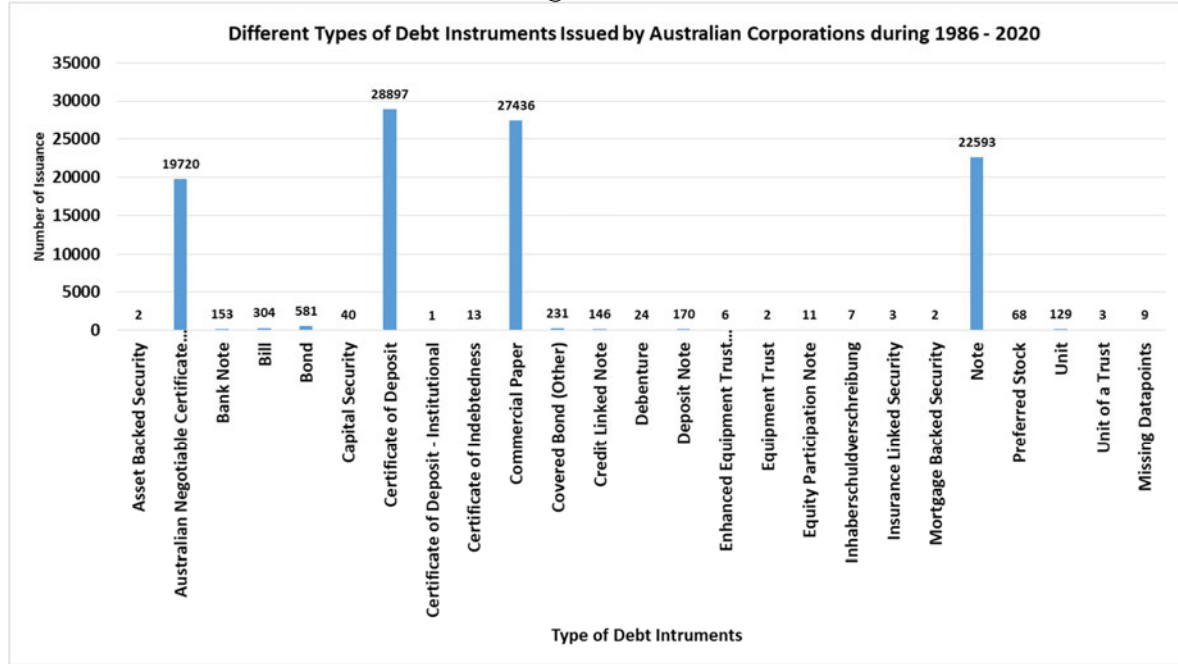




Figure 3 - a

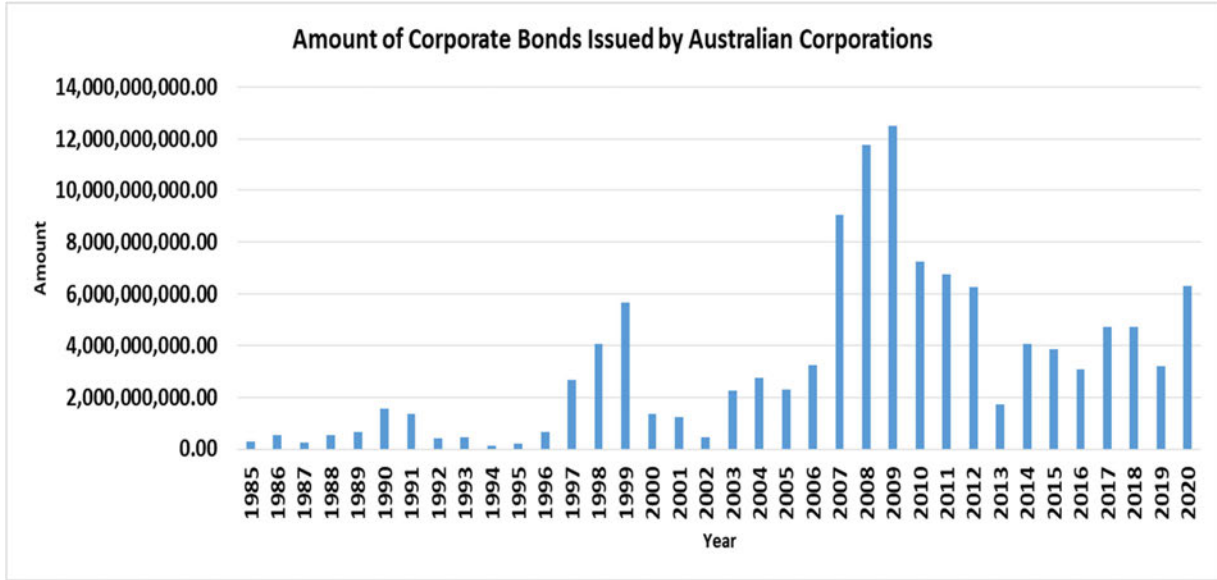


Figure 3 - b

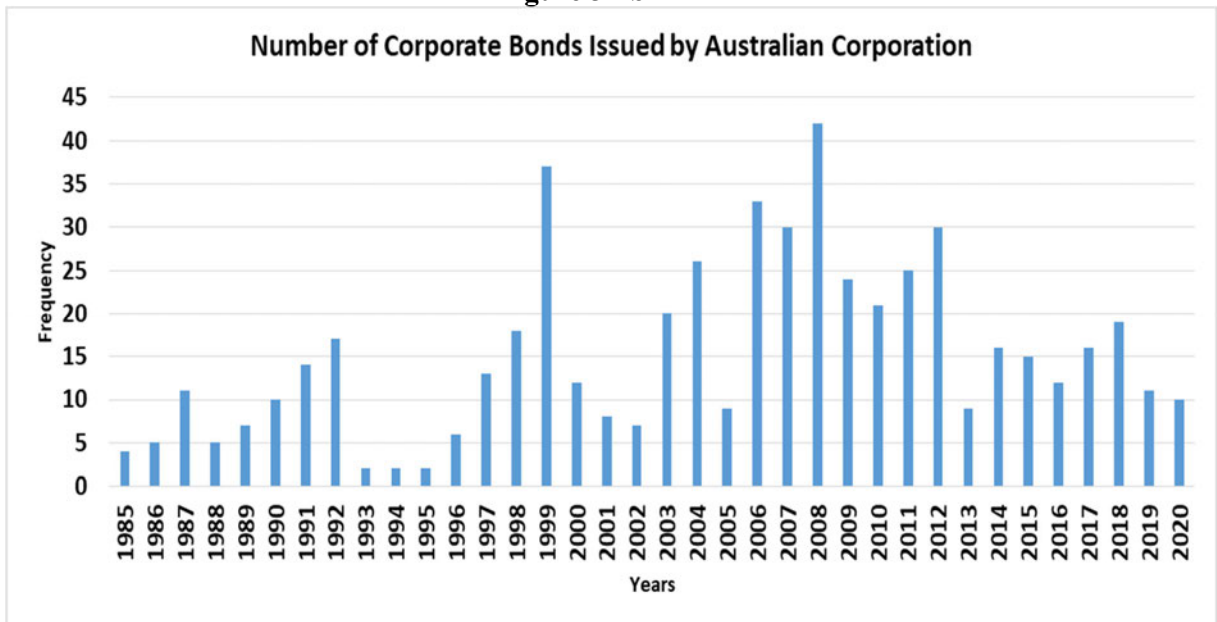




Figure 4 - a

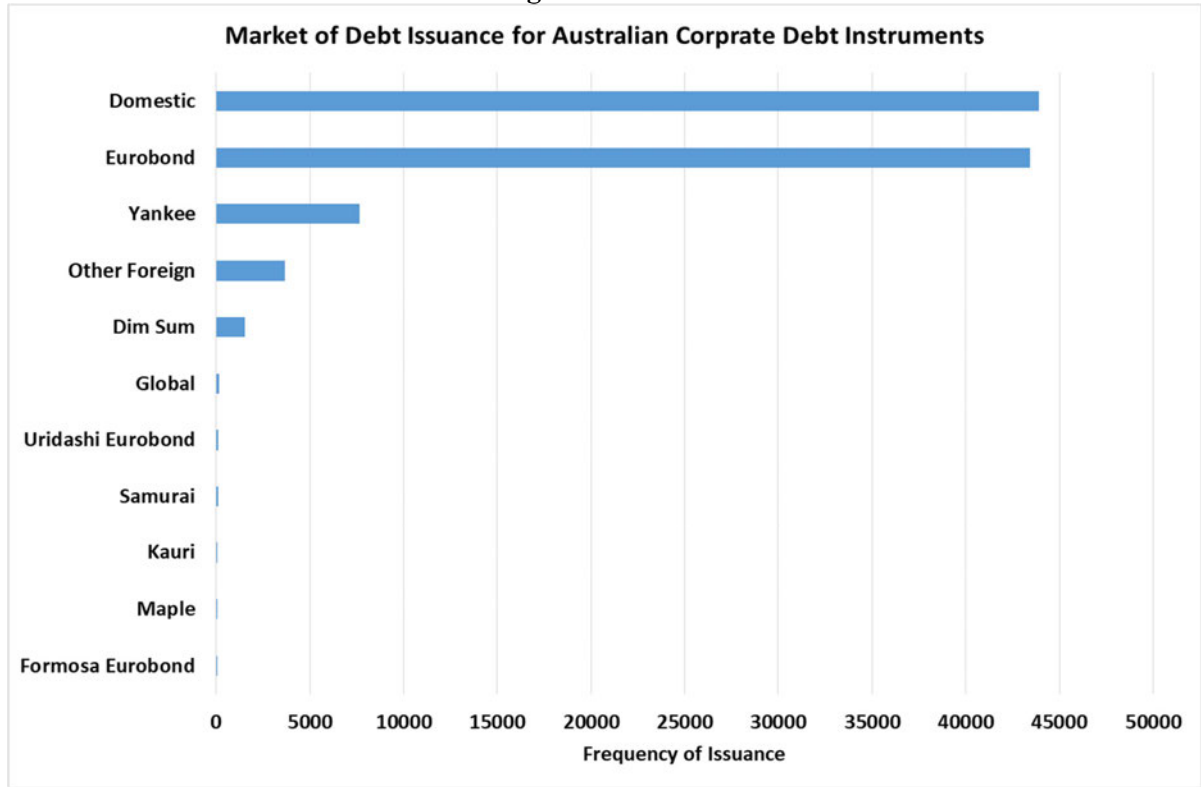


Figure 4 - b

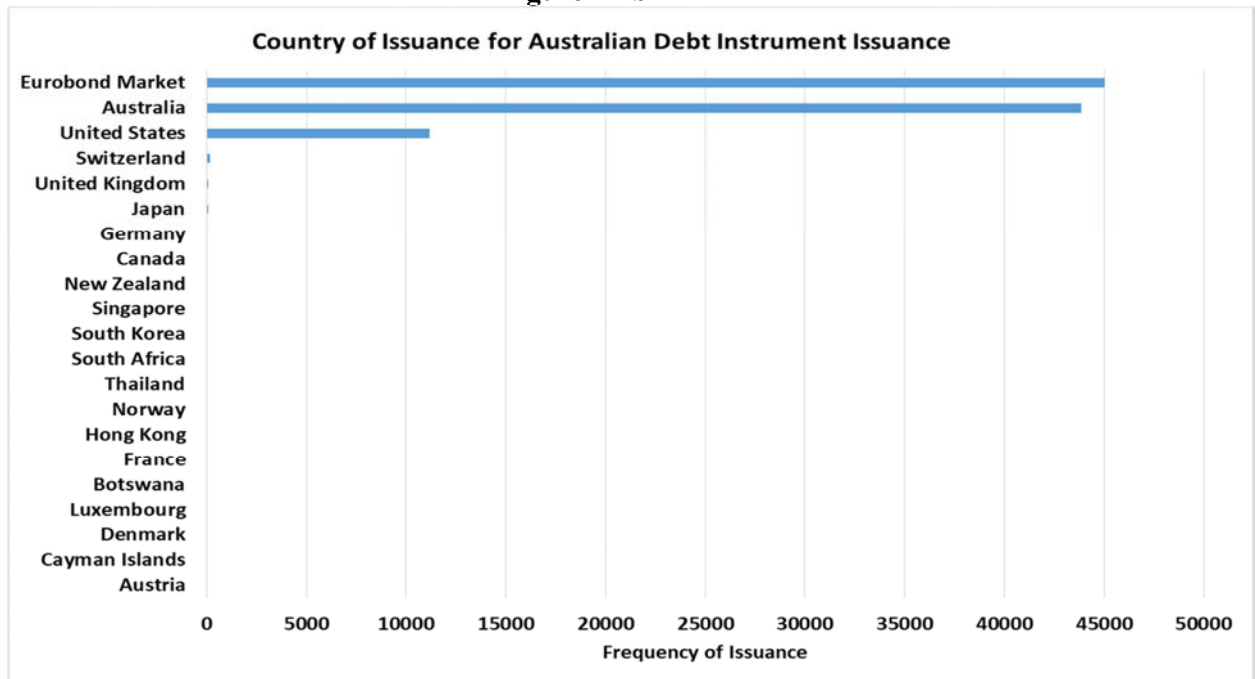




Figure 5 - a

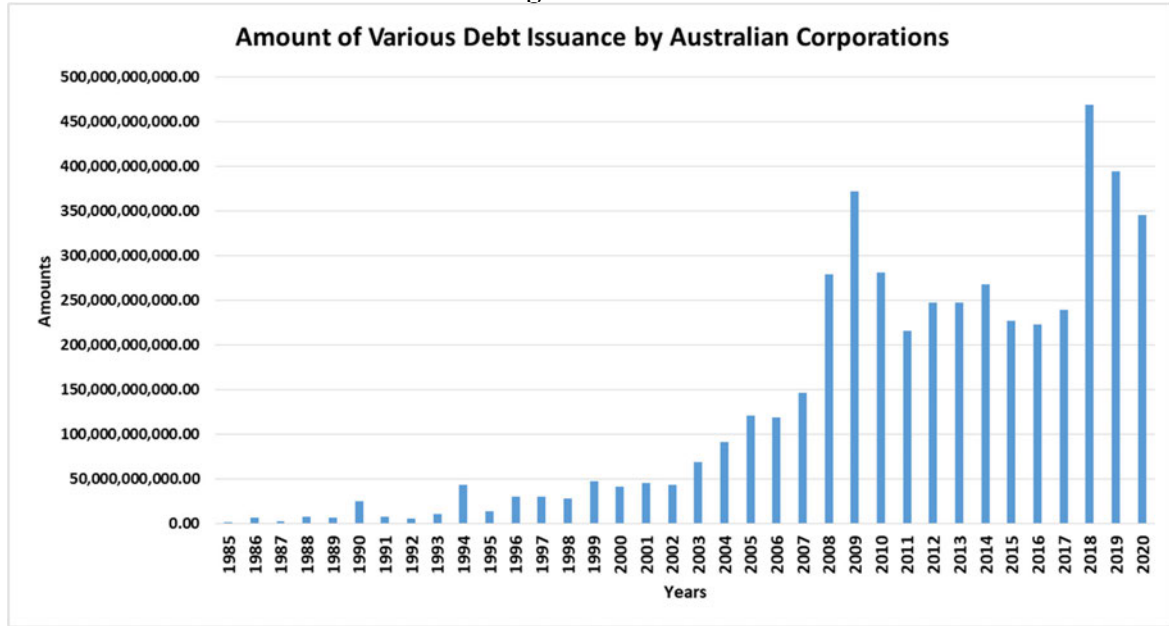


Figure 5 - b





Figure 6 - a

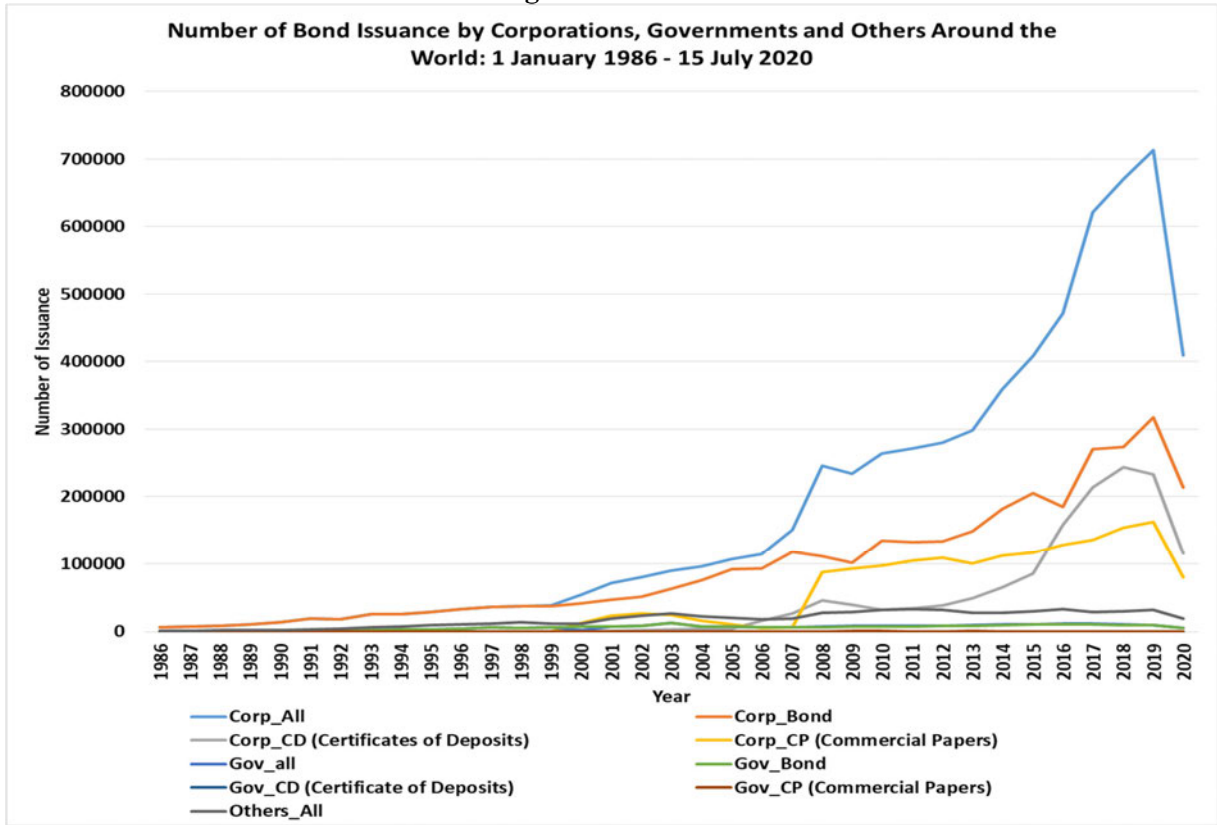


Figure 6 - b

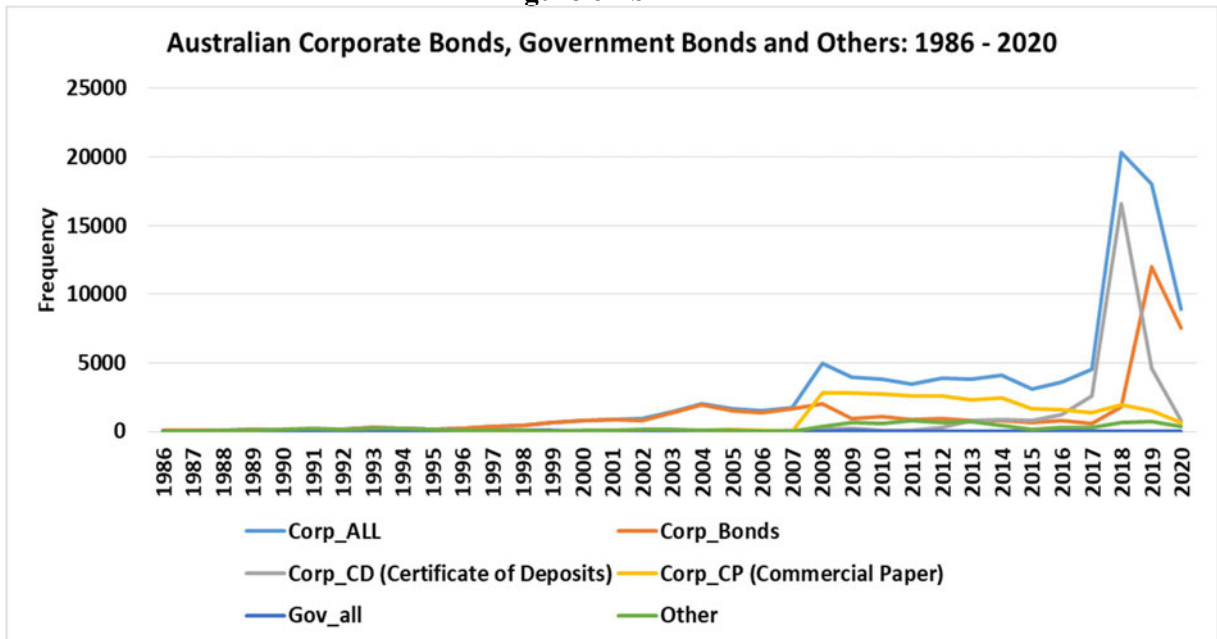




Figure 6 - c

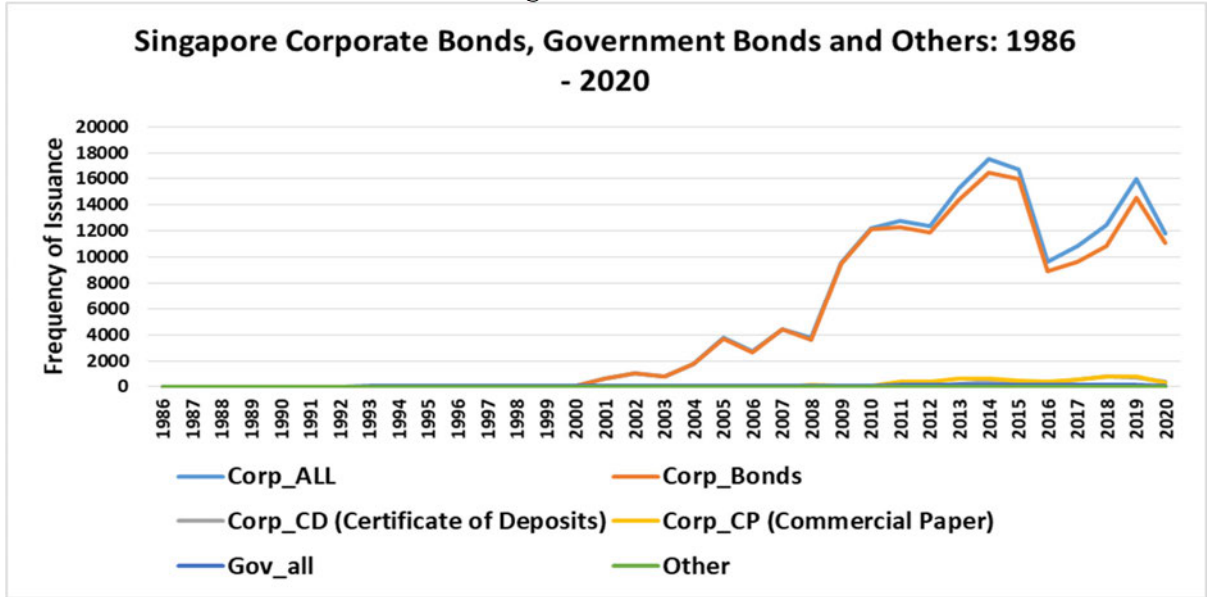


Figure 6 - d

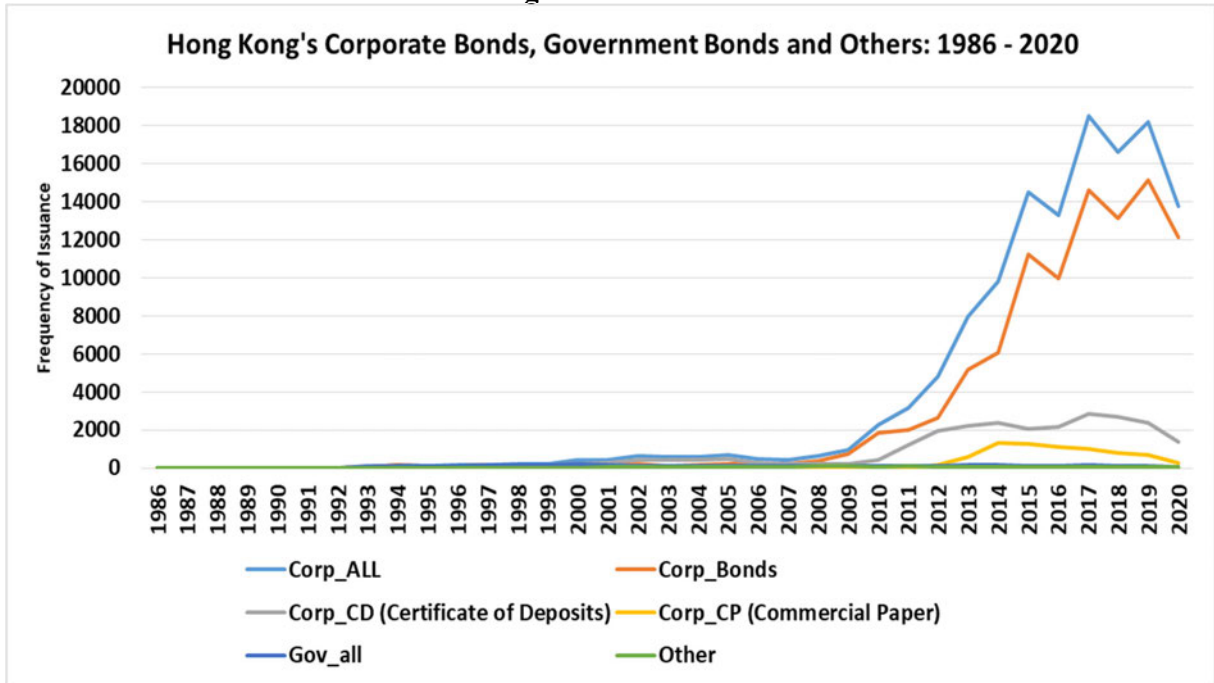




Figure 7a

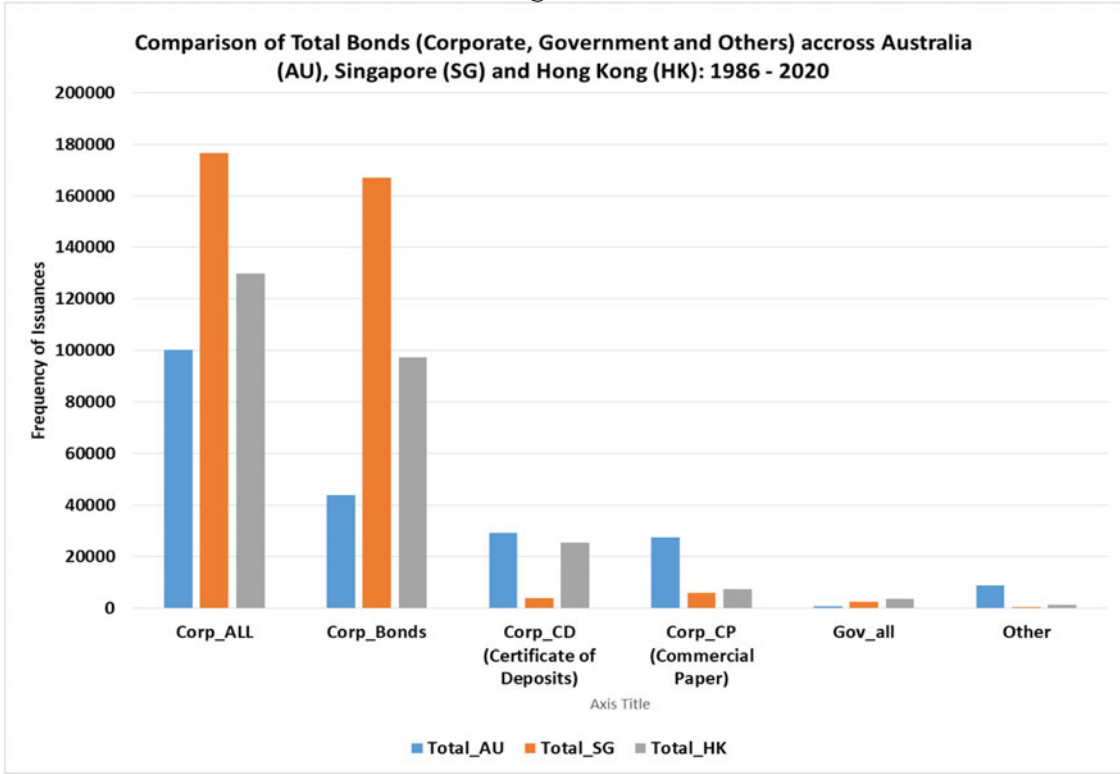


Figure 7b

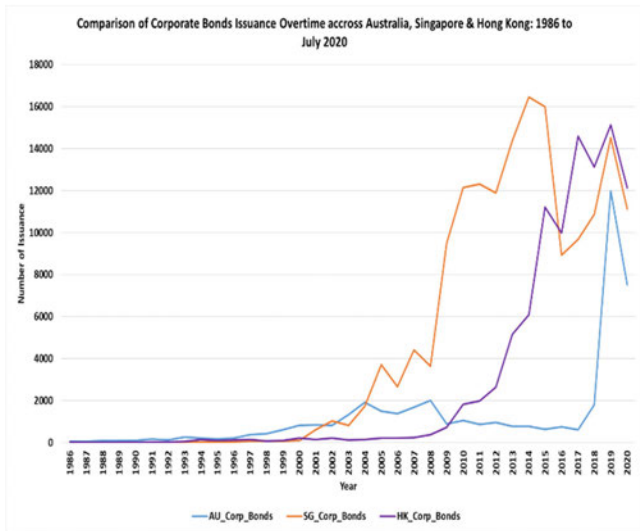


Figure 7C

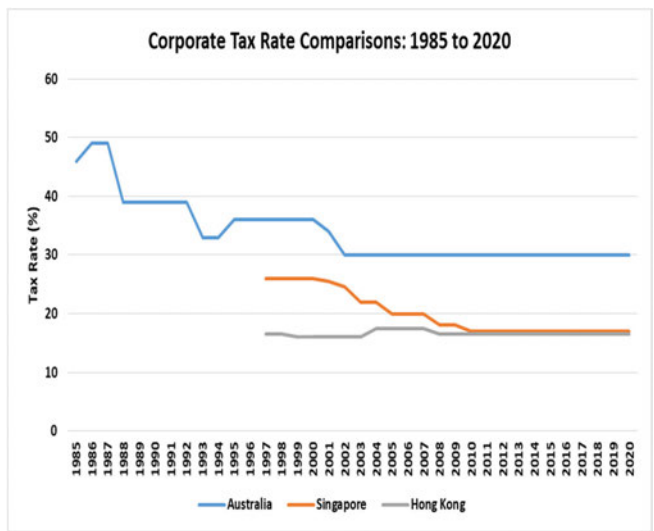




Figure 8

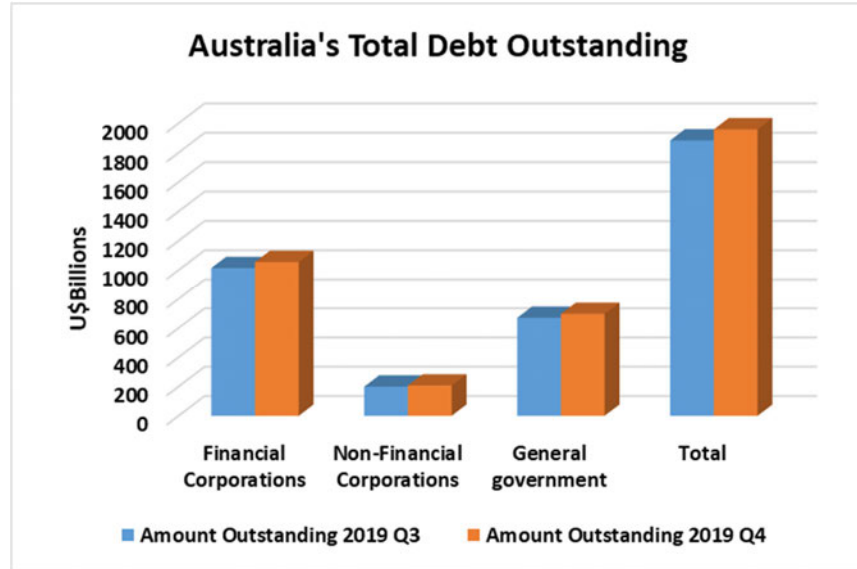
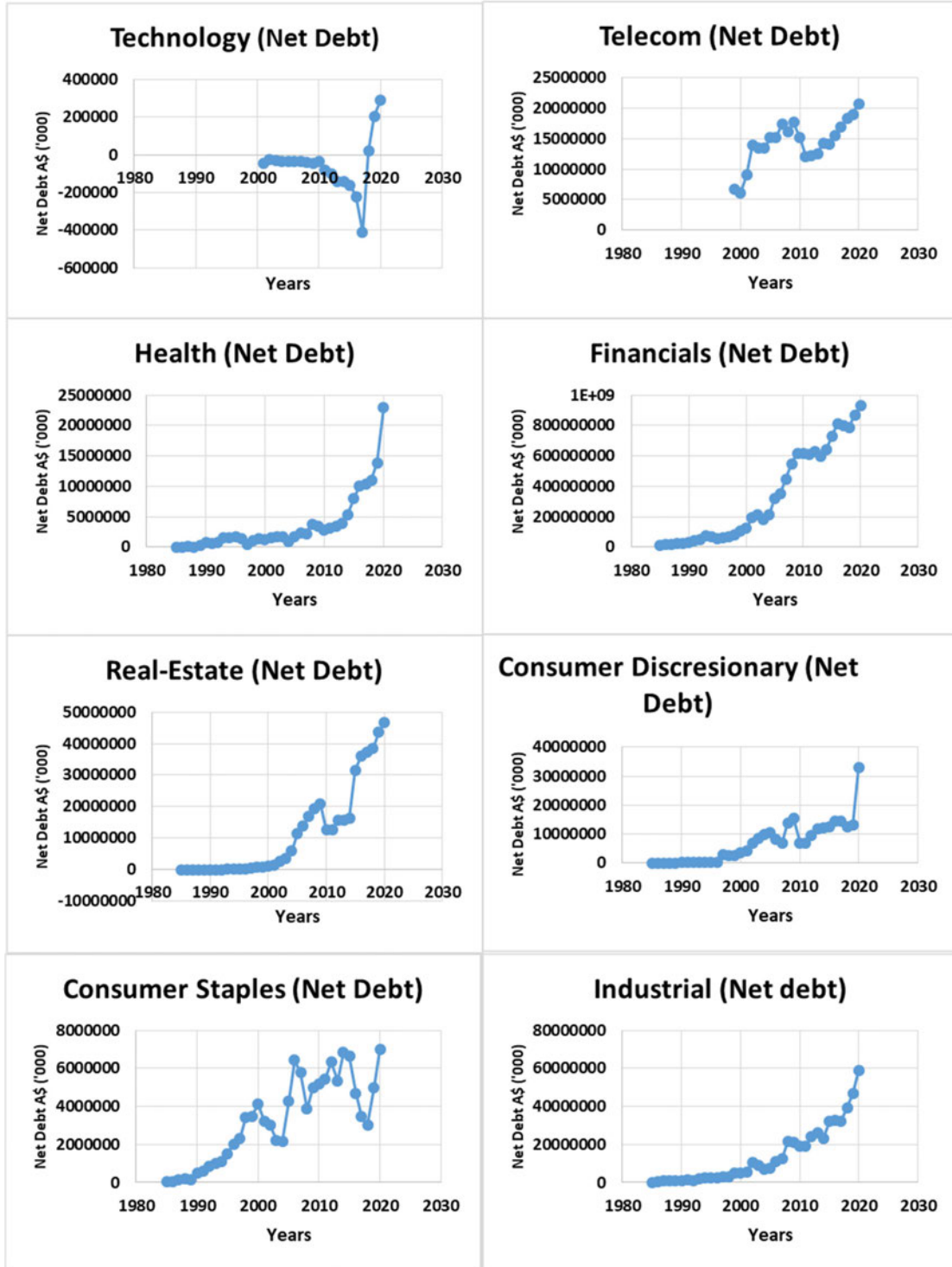




Figure 9: Different Industry level Net Debt across Years



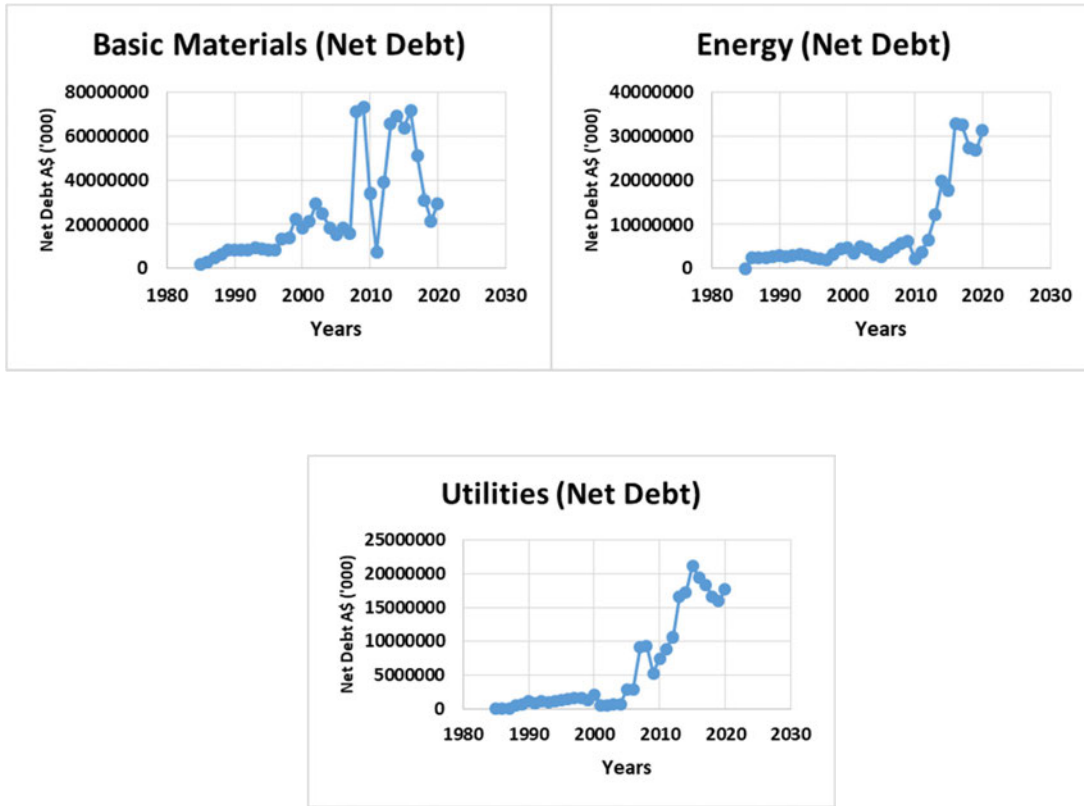


Figure 10

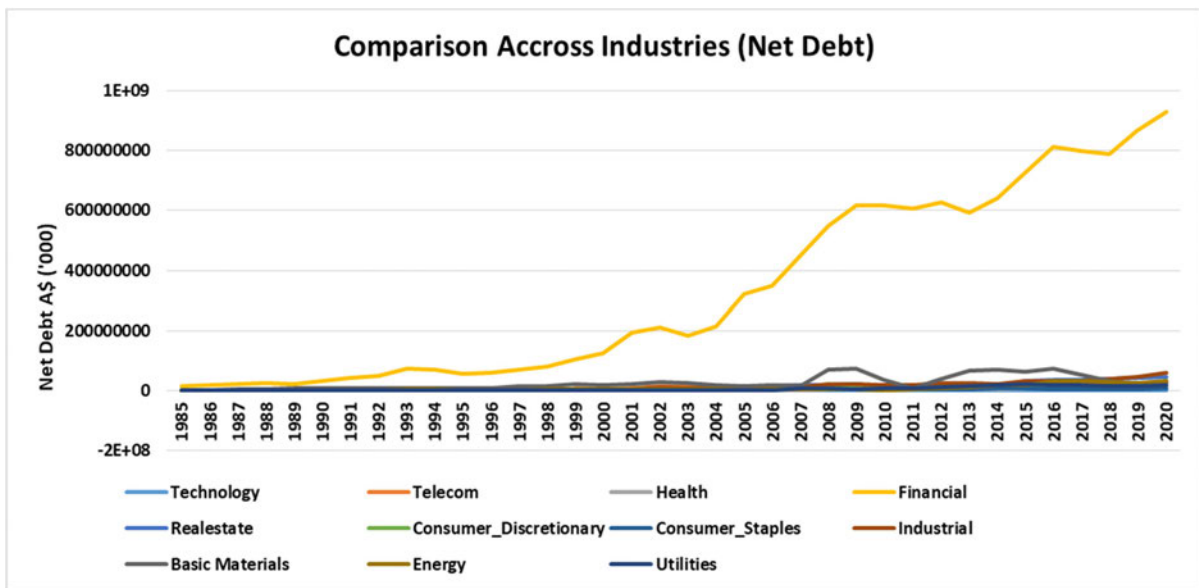




Figure 11

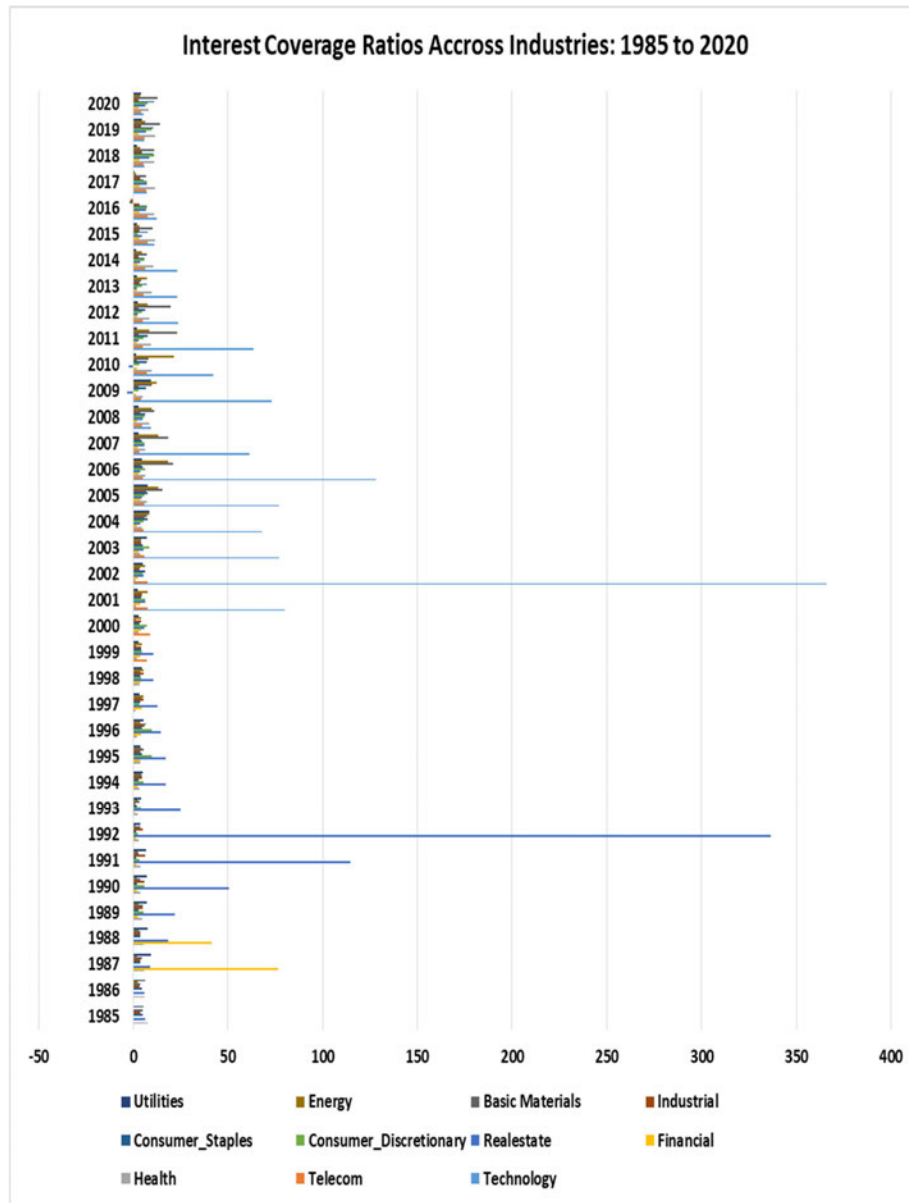
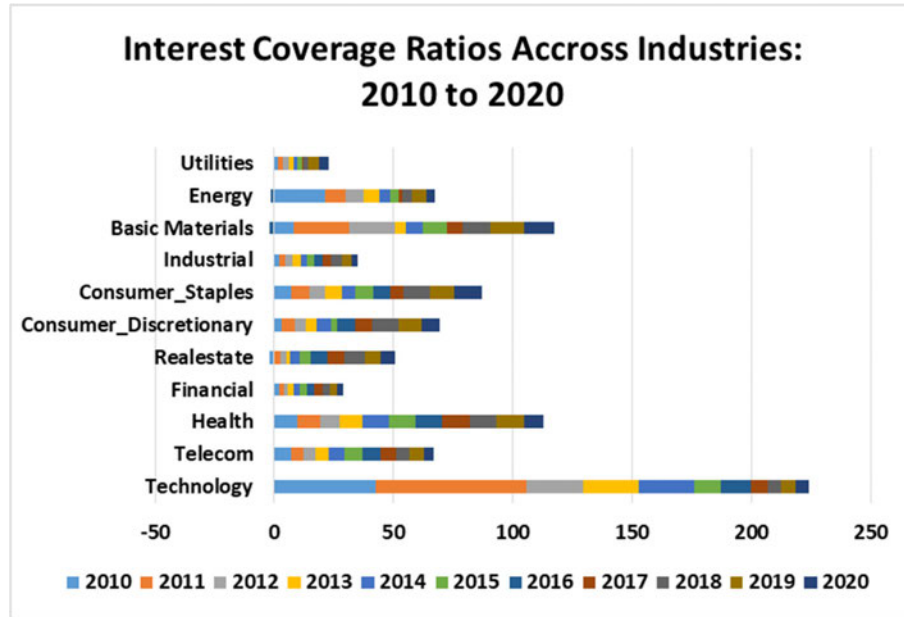




Figure 12





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[https://www.ato.gov.au/Business/Taxation-of-financial-arrangements-\(TOFA\)/](https://www.ato.gov.au/Business/Taxation-of-financial-arrangements-(TOFA)/)

Source of Data for Graphs/Figures and Table Production: Bank of International Settlement, Thomson Reuters, Eikon, SDC Platinum, Capital IQ, BvD, Morning Star, Worldscope, Bloomberg and DataStream, Refinitive, Trading Economics, OECD, ATO and World Bank