

The House of Representatives Committee on Tax and Revenue

Development of the Australian Retail Corporate Bond Market

Submission by Senator Gerard Rennick

Competitive corporate financing is a sign of mature, well-regulated and developed economy. A competitive market improves efficiency and delivers superior outcomes. An appropriately competitive market can only exist where regulatory settings are blind so as to not preference a single class of business, investor or supplier. The current policy and legislative settings around the retail corporate bond market fail to do this.

Offshore bond markets are given distinct and almost deliberate advantages by the Australian taxation system when it comes to debt financing in corporate Australia. Australian lenders are subject to the full corporate tax rates on their interest margin. On 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. This exemption costs the budget close to \$2.5 billion dollars annually and is borne by the Australian taxpayer. Most foreign lenders are either banks or sovereign wealth funds.

If the foreign lender has structured a special purpose funding vehicle in a nil or low taxing jurisdiction, they will pay a much lower tax rate on their interest margin than an Australian lender.

This will have ramifications for onshore entities looking to borrow. Because offshore debt has a lower tax rate, the cost of foreign debt will be lower than domestic debt. As a result onshore entities will use foreign debt to fund their operations, which will lead to greater capital outflows in the form of interest payments and a greater reliance on foreign debt.

Whilst, in theory supporting cheap access to capital may be a good thing, the fact remains this is in effect a reverse tariff on Australian lenders, and gives foreign businesses a distinct advantage over domestic ones. We would not tolerate a tariff the other way, yet to attract foreign capital we have constructed a tax system that arbitrarily discriminates against Australian lenders.

Furthermore, it should be argued that the source of income is not the offshore *resident* country of the lender but the onshore *source* country. i.e. Australia. It is time the major OECD countries reviewed the tax treaties that tax corporations based on residency rather than source. When the tax treaties were originally agreed upon, it was assumed that resident country would be an OECD country and *indirect profits* such as interest, royalties and rent would be repatriated to the OECD country. In order to avoid what was generally higher taxes in OECD countries, companies set up subsidiaries in low taxing jurisdictions to reduce tax by redirecting indirect profits those low tax jurisdictions.

This exemption for withholding tax for interest paid on debentures issued from offshore has applied for the best part of twenty five years. Amendments have been made repeatedly which gave further concessional treatment to overseas bond issuers. In 2003, additional amendments were made which

again made it easier for overseas lenders to undercut Australian investors on price through the taxation system. Amendments were made to allow concessional treatment for amounts paid which were deemed interest- in essence taxing profits made from lending in Australia was again paired back. Secondly, the legislation originally made it difficult to claim an exemption for a company that was ostensibly lending to its associates. This was for the obvious reason of ensuring that companies did not create other shell companies to lend to themselves- ostensibly legalised tax avoidance through tricky and creative accounting. The definition of an associate for the purposes of this section of the act was narrowed, the reasons given was to remove impediments to the issue of further bonds in Australia. In practice this has enabled companies to lend to themselves without much scrutiny of the fashion in which they are operating to avoid paying tax.

Given the context of this inquiry is to create or at least give fair opportunity to a domestic retail corporate bond market, the first solution is to raise withholding tax rates so they are commensurate with or even above the tax rates incurred by lenders in Australia. To ensure no double taxation, the foreign lender should be entitled to a tax offset on the tax payable in its resident country. If the foreign lender is worse off, this can be resolved by setting up a permanent establishment in Australia which will ensure that double taxation doesn't apply by applying transfer pricing rules. Taxing should focus on cumulative rate of tax paid between two countries rather than double taxation.

Ideally the Australian government should seek to ensure that 50% of the profits sent offshore from payments such as interest, royalties are declared as assessable income in Australia and taxed at the same rate as income earned in Australia. In the case of payments to tax havens, where zero tax is payable, the Withholding Tax should be raised to match the same rate (or a little higher) as the onshore tax in Australia.

Ireland for example has a corporate tax rate of 10 cents but a withholding tax (on some items) of 15 cents. This will encourage capital into Ireland but punish that is sent from Ireland.

The inevitable counter argument to this is that because many of Australia's core industries are particularly capital intensive (mining, agriculture) Australia needs to attract or welcome foreign capital given our small population size. Whilst all investment is welcome, our country does not need to give special treatment to foreigners to attract investment and capital. With over 3 trillion dollars in funds superannuation is larger than gross domestic product and continues to grow. Superannuation could and should be used to fund Australian industry. Superannuation alone disproves the myth Australia has a shortage of capital.

It should be noted that significant tax concessions and subsidies for capital invested by General Motors did not save the Australian car industry. (Note Industrial relations also played a role here.)

The argument that large companies will leave Australia if withholding taxes are increased also fails to pass muster. Big capital intensive projects like mining and agriculture can't be offshored. Our minerals and fertile land cannot be picked up and taken elsewhere.

It is clear that the solution to the development of an Australian retail corporate bond market is to stop kneecapping our own lenders with a tax system that favours offshore lenders. This has only created a system that has led to greater capital outflows and an over reliance on foreign debt.

It should also be noted that Australia is one of the few countries in the world to allow the offset of franking credits on dividend income. It is therefore preferable for many Australian investors to purchase equity in Australian companies rather than lend to Australian companies.