# Chapter 3

# Issues in relation to Schedules 1 and 2

## Schedule 1—Small business capital gains tax concessions

3.1 The committee received a submission and accompanying paper in relation to Schedule 1 from Dr Mark Burton at the Law School, University of Canberra.[1] Dr Burton argues in his paper that small business tax concessions are being made and regularly increased with minimal impartial and credible critical scrutiny as to the effectiveness of the program. Specifically in relation to the small business capital gains tax concessions, he states that:

> …in the absence of publicly available data as to the beneficiaries of these captial gains concessions, and the use to which the benefit of the concessions is put, it is impossible to assess the merits of the concessions.[2]

3.2 Although Dr Burton's paper does not specifically addresss Schedule 1 of the bill, he expressed concern about the proposed extension of the small business CGT concessions:

> It is with considerable concern that I see that the Australian government proposes to expend a further $100 million dollars without, apparently, undertaking any credible study justifying such expenditure. I also note the compressed timeframe allowed for scrutiny of this proposed measure. Both aspects of the process by which this measure has arisen give great cause for concern if Australia is, truly, to achieve a minimum standard of public accountability.[3]

## Schedule 2—Exemptions from interest withholding tax

3.3 Four of the five submissions received by the committee expressed concerns about the amendments in Schedule 2 of the bill. The Australian Financial Markets Association (AFMA) asserts, for example, that the amendments will 'reverse the interest withholding tax relief granted to certain non-debenture debt interests by the Government in 2005 and enable the introduction of regulations to potentially curtail the availability of the exemption for certain debentures previously eligible for relief.'[4]

3.4 The importance of Interest Withholding Tax (IWT) exemptions was highlighted by the AFMA which notes in its submission that the gradual extension of

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1 Dr Mark Burton, *Submission 5*.

2 Dr Mark Burton, *Submission 5*, Attachment: *Small business tax advantages – towards holism with a suggested definition, typology and critical review*, p. 19.

3 Dr Mark Burton, *Submission 5*.

4 Australian Financial Markets Association, *Submission 4*, p. 1.

IWT relief over the last decade 'has benefited Australian consumers and business by providing a broader range of cost effective finance and it has assisted the development of our financial markets.'[5]

3.5 Specifically, several submissions focused on the effect of the changes on the syndicated loan market. As described by the Reserve Bank,[6] the borrowing requirements of businesses are sometimes beyond the funding and credit risk capacity of single lenders. As a result, some loans are arranged as syndicates with the funds jointly provided by two or more lenders. Though there is a single loan agreement, each participant to a syndicated loan maintains a separate claim on, and bears the credit risk for, the portion of the loan that it has provided. The amounts of such loans are typically large and the syndicated loan market in Australia has expanded rapidly in recent years. The broadening of the IWT exemptions following the amendments to the *Income Tax Assessment Act 1936* (ITAA) in 2005, allowed syndicated loans that called on international funds to attract the IWT exemptions in sections 128F and 128FA of the Act.

3.6 Some submitters now hold concerns that Schedule 2 of the bill will reverse the existing situation and will 'prejudice the ability of Australian firms to participate in the syndicated loan market'[7] because without the IWT exemption, Australian borrowers will be forced to pay more for the cost of capital as non-resident lenders will charge higher rates on loans to compensate for IWT.

3.7 The amendments in Schedule 2 introduce regulation making powers into sections 128F and 128FA. These powers will allow the Minister to specify the debt interests that will fall under the exemption from IWT in the sections, as well as the circumstances under which the interest paid by a company or trustee will not qualify for the exemptions. Submissions generally opposed this approach. The concerns fall into the following categories and these will be considered below:

- the appropriateness of utilising regulations rather than including the provisions in the Act itself;
- the uncertainty created by the chosen mechanisms;
- the retrospective effect of the provisions; and
- the possibility that certain debentures might be denied the IWT exemption by regulation.

### *Inclusion of matters in regulations rather than in the Act*

3.8 The Australian Banking Association (ABA) considers that the matters in question go to the heart of the operation of section 128F and such substantive issues

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5 Australian Financial Markets Association, *Submission 4*, p. 1.

6 *Syndicated Lending*, Reserve Bank Bulletin, September 2005.

7 Australian Bankers' Association, *Submission 1*, p. 1.

must be included in the primary legislation.[8] Specifically, as regards items 4 and 7 which allow for exclusions from the IWT exemptions to be made in 'prescribed circumstances', the ABA insists that this should be done in the principal Act:

> Measures of this nature can have effectively retrospective operation. The proper application of the rule of law, and the protection of Australia's reputation in international financial markets, demands that any withdrawal of a tax concession should occur via amendment to the primary legislation, with full Parliamentary consideration.[9]

3.9 Additionally, as a practical matter, the ABA suggests that developing and promulgating tax regulations is often a drawn out exercise and the length of the process and consequent uncertainty would be an unreasonable imposition on Australian and foreign market participants.[10]

3.10 The Institute of Chartered Accountants in Australia (ICAA) went further and disputed whether there is a need for a regulation making power at all. The ICAA attributed the motivation for the proposed changes to apparent Treasury and Australian Taxation Office (ATO) concern that 'interest on some term deposits and other standard bank accounts…might qualify for the IWT exemption inappropriately.'[11] However, according to the ICAA, there are more efficient ways of excluding such deposits from the exemption; and that it is 'not aware of any other financial instruments in respect of which the ATO and Treasury have similar concerns'. The ICAA concluded that accordingly, there is no need for any other exclusions, and no need for a power to make regulations to exclude particular instruments.[12]

3.11 Questioned about why particular instruments were to be included or excluded via the regulation power instead of via legislative amendment, Treasury and ATO officers said that this approach provides the Government with the flexibility to address developments in the market place.[13] The committee notes that the regulation power does allow the Government to respond to a fast evolving market considerably more quickly than would be the case if developments were addressed via legislation.

3.12 Treasury officers also assured the committee that it was not the Government's intention at this time to put forward regulations using the exclusion power.[14] This power is intended to be a reserve power to be used only if there is evidence of

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8 Australian Bankers' Association, *Submission 1*, p. 3.

9 Australian Bankers' Association, *Submission 1*, p. 3.

10 Australian Bankers' Association, *Submission 1*, p. 3.

11 Institute of Chartered Accountants in Australia (ICAA), *Submission 2*, p. 3.

12 Institute of Chartered Accountants in Australia (ICAA), *Submission 2*, p. 4.

13 Public hearing, 26 February 2007 – secretariat notes. (Transcript was not available at the time of preparing this report).

14 Public hearing, 26 February 2007 – secretariat notes.

systemic attempts to broaden the types of instruments eligible for the IWT exemption beyond those intended in the policy.

### *Uncertainty*

3.13 The regulations are not currently available in draft form and so it is unclear what debenture and debt interests will be excluded from and entitled to the IWT exemption in comparison to the current situation. The AFMA suggests that a taxpayer in the course of preparing a financing arrangement that is a debenture cannot be certain that the arrangement will not be prescribed by a regulation.[15] It argues that such a scenario will create uncertainty and generate additional compliance costs which, contrary to the statement in the Explanatory Memorandum, will not be 'negligible'. The AFMA suggests that these concerns are exacerbated by the absence of clear principles to govern the application of the regulations to particular arrangements.

3.14 The mechanisms chosen in the bill were also cited in submissions as creating uncertainty. The ABA takes issue with the continued reliance on the 'somewhat ill-defined and archaic description of a “debenture”' as a means to identify debt interests that are entitled to IWT exemption.[16] The AFMA considers that the approach in the bill would undermine the principle of tax neutrality across economically similar products that is a feature of the current law.[17]

> Businesses borrowing in the wholesale markets can avail of a range of facilities without incurring a withholding tax liability. At present, it is not necessary to utilise one debt instrument in preference to another that is in substance the same, but is more convenient or incurs lower transaction costs, because the withholding tax outcome is different. Similarly, lenders apply the same internal credit policies and management procedures to debt interests that are in substance the same.[18]

3.15 The Asia Pacific Loan Market Association (APLMA), which endorsed the ABA submission, also submitted that its major concern was in relation to the uncertainty that the bill has caused in respect of the syndicated loans market.[19]

3.16 The ICAA also addressed the issue of uncertainty, telling the committee that this arises partly out of how the legislation is drafted, and partly out of the regulation power. Mr Duncan Baxter of the ICAA said that there is concern within the industry that because of the way the amendments have been drafted, there is the potential to

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15 Australian Financial Markets Association, *Submission 4*, p. 2.

16 Australian Bankers' Association, *Submission 1*, p. 3.

17 Australian Financial Markets Association, *Submission 4*, p. 2.

18 Australian Financial Markets Association, *Submission 4*, p. 2.

19 Asia Pacific Loan Market Association (APLMA), *Submission* 4, p. 1.

exclude almost any form of debt interest.[20] The ICAA representatives said that they preferred the use of legislation rather than regulation because of the level of certainty provided.[21]

3.17 The ABA and the AFMA suggest that a preferable mechanism to achieve the aim of preserving the tax system integrity would be to utilise what the ABA terms a 'negative list'.[22] This approach would recast the provisions in the bill so that regulations are used only to exclude specified arrangements or debt interests that would create a risk to the tax revenue.

3.18 Mr Tony Burke, Director, ABA told the committee that the ABA had put forward suggested amendments for the Treasury to consider in place of the approach in the bill.[23] He said that the ABA's suggested amendments directly target the concerns of the Treasury and ATO and removed the regulatory risk problem that is of concern to the market.

3.19 Treasury officers confirmed that the Government was considering the ABA's proposed amendments.[24]

***Retrospectivity***

3.20 The amendments limiting eligible debt interests to non-debenture debt interest that are non-equity shares will apply to debt interests issued on or after 7 December 2006 (which was the day on which the bill was introduced into the House of Representatives). Contrary to the statement in the Explanatory Memorandum that the amendments will have no financial impact, several submissions assert that the bill will be retrospective and will effectively impose costs via interest withholding tax 'gross up' clauses on Australian borrowers who negotiated loan arrangements in good faith based on current law.[25]

3.21 Submissions suggest that certain syndicated loan facilities in particular may be affected by the legislation with retrospective effect. Those facilities that were arranged prior to 7 December 2006 but which would have amounts drawn down after that date, would be affected by any regulations that were formulated to exclude them from the IWT exemption.

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20 Public hearing, 26 February 2007 – secretariat notes.

21 Public hearing, 26 February 2007 – secretariat notes.

22 Australian Bankers' Association, *Submission 1*, p. 2; *and* Australian Financial Markets Association, *Submission 4*, p. 2.

23 Public hearing, 26 February 2007 – secretariat notes.

24 Public hearing, 26 February 2007 – secretariat notes.

25 Australian Bankers' Association, *Submission 1*, p. 1.

3.22 The APLMA was amongst those who contended that the date of effect amounted to retrospective effect in respect of 'drawdowns on pre 7 December 2007 128F compliant facilities'.[26]

3.23 The ICAA did not describe the proposed changes as being retrospective, but did make similar points to the other submissions in relation to interests that issuers may not have issued but to which they were nonetheless committed. The ICAA noted that the proposed transitional rules only preserve the existing treatment for interests issued as at the operative date, but submitted that this should be extended to include interests and facilities to which the issuer was committed as at that date.[27]

3.24 The ICAA argued that there is a need to ensure that the transitional rules preserve the existing treatment for a range of circumstances including:

- debt interests to which an issuer was already committed but had not yet issued any interests;
- staggered draw-downs already partly issued;
- redraws;
- rollovers;
- novations; and
- facilities issued that are varied after the operative date.[28]

3.25 Treasury officers advised the committee that it was not the intention in the legislation to unwind currently accepted practices.[29] Rather, the legislation, including the regulation making power, was developed to re-affirm the Government's policy in relation to the instruments intended to be eligible for the IWT exemption. The legislation also responds to 'interpretive pressure' to broaden the exemption to other products, such as certificates of deposit to be made available to the retail market.

***Potential exclusion of debentures from the IWT exemption***

3.26 The ICAA noted that the regulation making power would extend to debentures as well as other debt interests. It submitted that there is 'no policy need to suddenly exclude particular debentures from the exemption'.[30]

3.27 Treasury officers emphasised that there was no intention at the present time to use the regulation making power to exclude existing arrangements.[31]

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26 Asia Pacific Loan Market Association (APLMA), *Submission* 4, p. 1.

27 Institute of Chartered Accountants in Australia (ICAA), *Submission 2*, p. 4.

28 Institute of Chartered Accountants in Australia (ICAA), *Submission 2*, p. 4.

29 Public hearing, 26 February 2007 – secretariat notes.

30 Institute of Chartered Accountants in Australia (ICAA), *Submission 2*, p. 3.

31 Public hearing, 26 February 2007 – secretariat notes.

## Committee comments

3.28 The committee notes evidence received that the introduction of the bill has given rise to a degree of uncertainty in relation to whether some debentures and other debt instruments will be excluded from current IWT exemptions. Industry concern is focussed in particular on whether syndicated loans will continue to qualify for the IWT exemption, although there are also broader concerns about other products. These concerns originate from the relatively broad powers in the bill allowing debt instruments to be either included or excluded from IWT exemption, and from the absence of detail in relation to the regulations.

3.29 The committee also notes concerns about transitional arrangements and the implications of the commencement date for the legislation on instruments such as staggered loans only partially issued, redraws, rollover loans and other loan facilities varied after the operative date.

3.30 The Treasury has explained that this legislation is intended to re-affirm the Government's policy in relation to the instruments intended to be eligible for the IWT exemption and to respond to 'interpretive pressure' to broaden the exemption to other products. It is not intended to unwind currently accepted practices. As such, it does not appear that concerns about transitional arrangements or the future exemption of products such as syndicated loans are well founded.

3.31 Nonetheless, the committee considers that it would be desirable for the Government to re-examine the issue of transitional arrangements, to ensure that appropriate grandfathering arrangements are in place. The committee also considers it desirable for the Government to respond to concerns raised about the future status of syndicated loans.

3.32 The ABA has put forward amendments for the Government's consideration as an alternative to the approach in the bill. The ICAA has also made direct representations to the Government in relation to its concerns. The Government is yet to respond to the ABA's proposed amendments or to the ICAA's representations.

**Recommendation 1**

3.33 **The committee recommends that the Senate pass the bill.**

Senator the Hon Michael Ronaldson
**Chair**