The Senate

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# Standing Committee on Economics

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## Tax Laws Amendment (2006 Measures No. 7) Bill 2006 [Provisions]

February 2007

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# Senate Standing Committee on Economics

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# Chapter 1

## Introduction

### Background

1.1 The Tax Laws Amendment (2006 Measures No. 7) Bill 2006 was introduced into the House of Representatives on 7 December 2006. It passed the House without amendment and was introduced into the Senate on 7 February 2007.

1.2 On 8 February 2007, on the recommendation of the Selection of Bills Committee, the Senate referred the bill to the Standing Committee on Economics for inquiry and report by 27 February 2007.[1]

1.3 The bill is an omnibus bill that implements a number of changes to Australia's taxation system in the areas of: small business CGT concessions; interest withholding tax exemptions; deductible gift recipients; effective life of tractors and harvesters; farm management deposits; and capital protected borrowings.

### Conduct of the inquiry

1.4 The committee advertised the inquiry in the *Australian* newspaper on 14 February 2007 and invited written submissions by 16 February 2007. Details of the inquiry were placed on the committee's website. The committee also wrote to a number of organisations and stakeholder groups inviting written submissions.

1.5 The committee received five submissions. These are listed in Appendix 1. A public hearing was held in Canberra on 26 February 2007. Witnesses who presented evidence at this hearing are listed in Appendix 2.

1.6 The Committee thanks those who participated in this inquiry.

### Structure of the report

1.7 Four of the five submissions received by the Committee made comment only on Schedule 2 of the bill. The fifth submission commented only on Schedule 1. Consequently, this report provides a brief outline of the amendments in all Schedules of the bill but concentrates on the amendments in Schedule 2 that relate to interest withholding tax exemptions.

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1 Selection of Bills Committee, *Report No. 2 of 2007*, dated 8 February 2007.

# Chapter 2

## The bill

2.1 This bill is an omnibus bill that will implement changes to the Australian taxation system in the following areas:

- small business capital gains tax concessions;
- exemptions from interest withholding tax;
- integrity arrangements and compliance requirements for deductible gift recipients ;
- extensions to certain deductible gift recipients;
- effective life of tractors and harvesters;
- farm management deposits; and
- capital protected borrowings.

2.2 An outline of the provisions of the bill's various Schedules follows.

### Schedule 1—Small business capital gains tax provisions

2.3 The small business capital gains tax (CGT) provisions in Schedule 1 of the bill arise in part from the recommendations of the Board of Taxation[1] that were accepted by the Government.

2.4 Schedule 1 is intended to reduce the compliance costs for small business and increase the availability of the small business CGT concessions. It makes changes to the following:

- the maximum net asset value test;
- the active asset test;
- the 15-year exemption;
- the retirement exemption;
- the small business roll-over; and
- the application of concessions to partners in a partnership and deceased estates.

2.5 Amendments also replace the controlling individual 50 per cent test with a significant individual 20 per cent test that can be satisfied either directly or indirectly through one or more interposed entities. The objective is to make the controlling

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1 Board of Taxation, *A Post-implementation Review of the Quality and Effectiveness of the Small Business Capital Gains Tax Concessions in Division 152 of the Income Tax Assessment Act 1997*, at: http://www.taxboard.gov.au/content/small_business_CGT/CGT_Report.asp

individual test less onerous so that the small business CGT concessions can be accessed by a broader range of small business taxpayers.

### *Standing Committee for the Scrutiny of Bills comment*

2.6 In its Alert Digest No. 1 of 2007, the Scrutiny of Bills Committee raised the issue of retrospective application in relation to Schedule 1, item 67. However, the Committee made no further comment on the provision because the Explanatory Memorandum states that the relevant amendment is beneficial to some taxpayers because it increases the availability of the small business capital gains tax concession.

## Schedule 2—Interest withholding tax exemptions

2.7 Subject to a number of exemptions, interest payments to non-residents are levied under Division 11A of the *Income Tax Assessment Act 1936* (the ITAA) with 10 per cent withholding tax. Exemptions for certain publicly offered debentures or debt interests are contained in sections 128F and 128FA of the Act. These exemptions for certain types of offshore borrowings are intended to ensure that Australian business does not face a higher cost of capital as a consequence of the imposition of interest withholding tax. The exemptions are targeted at arm's-length arrangements such as structured capital raisings for business activities and exclude related party transactions and individually negotiated loans.

2.8 The bill amends sections 128F (exemption on certain publicly offered **company** debentures or debt interests) and 128FA (exemption on certain publicly offered **unit trust** debentures or debt interests) to clarify the withholding tax exemptions.

2.9 Significantly, the bill also introduces a regulation making power to the sections to allow the Minister to specify which instruments will qualify for the exemptions and which will not qualify.

### *Background*

2.10 Before 2005, the exemptions from interest withholding tax (IWT) in the ITAA were limited to interest paid by a company or unit trust to non-residents for debentures that satisfied the public offer test and certain other conditions. However, in 2005, legislative amendments[2] extended the exemptions from interest on a debenture to interest on a debenture or a non-debenture debt interest. The extensions were made to reflect changes to Australia's 2001 debt/equity rules that arose from the development of innovative financing arrangements. The changes replaced legal form tests for characterising financing arrangements as debt or equity with tests of substance rather than form. These changes were made in response to the use in financial markets of

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2 These amendments were contained in the *New International Tax Arrangements (Managed Funds and Other Measures) Act 2005*.

instruments that were legally equity, but actually debt, or legally debt, but actually equity (this development is explained more completely in paragraph 2.15).

2.11 The 2005 amendments to section 128F of the ITAA enabled interest on debt interests under the new debt/equity rules to be eligible for the IWT exemptions, provided they also satisfied the other eligibility requirements and, in particular the public offer test (details of which can be found on pages 51-52 of the Explanatory Memorandum). For example, the 2005 changes enabled interest on close substitutes for debentures in capital raisings by companies, such as redeemable preference shares, to be eligible for the IWT exemption.

2.12 In a similar way to section 128F, section 128FA provides for exemption from IWT for interest payments to non-residents. Prior to the 2005 amendments, section 128FA provided for interest withholding tax exemption only for interest paid on debentures issued by the trustee of an eligible unit trust. The 2005 amendments to section 128FA were also driven by the 2001 debt/equity rule changes, and extended IWT exemptions to interest on debt interests that also satisfied the other eligibility requirements.

2.13 The ASFA online dictionary defines debentures as a type of interest-bearing security issued by companies.[3] Money invested in debentures is a secured loan. There is usually no specific security, but the debenture is supported by a charge over the assets of the company. Debentures generally raise money for the medium to long term — two to five years.

2.14 'Debenture' is currently defined for the purposes of sections 128F and 128FA of the Act to include debenture stock, bonds, notes and any other securities of the company (whether or not constituting a charge over the assets of the company), promissory notes and bills of exchange. The Explanatory Memorandum states that although there is some uncertainty about the scope of the terms 'debenture' and 'security' with both having broad common law meanings, relevant case law suggests the following:[4]

- a debenture is a transferable document that either creates or acknowledges a debt (rather than merely evidencing it);
- while promissory notes and bills of exchange are not customarily held to be debentures under common law, they were inserted into the definition of debenture in the Act for the purposes of these provisions; and
- savings accounts, transaction or current accounts, term deposits and non-transferable certificates of deposit would **not** generally be regarded as debentures or securities.

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3 Definition from the Association of Superannuation Funds of Australia Ltd (ASFA) online dictionary, at: http://www.superannuation.asn.au/Online-Dictionary/default.aspx

4 Explanatory Memorandum, p. 47.

2.15 'Debt interest' is defined by reference to Division 974 of the *Income Tax Assessment Act 1997*. It is a broad term that includes both financial instruments and financing arrangements, and embeds the concept of a non-contingent obligation to pay an amount to the holder of the debt interest, at least equal to its issue price, in the future. For the holder, this reflects receipt of a financial benefit, which need not amount to interest. It has resulted in certain financial instruments that would previously have been regarded as equity now being categorised as debt. Provided these debt interests give rise to interest, payment of that interest may attract IWT. It includes debentures and the range of standard retail and wholesale products offered by financial institutions (the Australian Taxation Office has publicly accepted as debt interests transferable certificates of deposit and syndicated loans) as well as hybrid debt/equity instruments such as non-equity shares.

2.16 The continuing requirement that debentures and debt interests meet the public offer test limits the range of debentures and debt interests qualifying for IWT exemption. However, according to the Explanatory Memorandum, on a strict legal form assessment, it is possible that certain financial instruments that have not traditionally been regarded as debentures could be interpreted as such:

> …interpretative pressure on the relevant law has the potential to substantially widen the range of debentures and debt interests that could qualify for exemption from interest withholding tax, beyond the original policy intent. This represents a threat to the integrity of the tax system.[5]

2.17 This appears to be the key driver of the changes in this Schedule.

2.18 Accordingly, the amendments in the bill are designed to restore the original purpose of the 2005 interest withholding tax amendments. The Explanatory Memorandum states that:

> The amendments clarify the range of interest payments to non-residents on non-debenture debt interests that qualify for interest withholding tax exemption, consistent with the policy intent at the time the original amendments were introduced in 2005. At that time, the Government had intended providing eligibility for hybrid financial instruments regarded as debt under Division 974 of the ITAA 1997. The most obvious example is a non-equity share, such as a redeemable preference share. The inclusion of a regulation-making power in the amendments to prescribe further eligible debt interests will enable other (possibly yet to be developed) hybrid instruments to be made eligible where they perform a similar capital raising role in similar circumstances to currently eligible debentures and debt interests. Regulations could also be made to provide transitional arrangements, as appropriate, in relation to debt interests issued since the 2005 amendments.

5 Explanatory Memorandum, p. 46.

***Standing Committee for the Scrutiny of Bills comment***

2.19 In its Alert Digest No. 1 of 2007, the Scrutiny of Bills Committee raised the issue of retrospective application in relation to Schedule 2, item 8. However, the Committee made no further comment on the provision because the Explanatory Memorandum states that the amendments will have no financial impact.

## Schedules 3 and 4—Deductible gift recipient arrangements

2.20 Australian taxpayers may claim an income tax deduction for gifts of $2 or more, or property, to eligible gift recipients known as deductible gift recipients (DGRs). DGRs are either endorsed by the Australian Taxation Office (the majority of DGRs) or listed by name in the tax law. For some DGRs, the income tax law adds extra conditions affecting the sorts of deductible gifts they can receive. For example, the gift may only be tax deductible between certain dates, or for a specific use.

2.21 As part of the DGR integrity arrangements, endorsed DGRs are required to maintain gifts and contributions in a separate fund. Schedule 3, in some cases, removes the requirement for DGRs to maintain gift funds; and for DGRs to maintain one gift fund rather than multiple gift funds. Further, the amendments standardise the integrity arrangements for all DGRs, so that listed DGRs can now be reviewed by the Commissioner in line with the Commissioner's current powers to review endorsed DGRs to determine if they continue to meet the conditions of their DGR status.

2.22 Schedule 4 of the bill extends the period for which deductions are allowed for gifts to four listed funds that have time limited DGR status.

## Schedule 5—Effective life of tractors and harvesters

2.23 As part of the Ralph Review recommendations,[6] the Australian Taxation Office is over time reviewing the periods over which assets can be depreciated. According to the Minister's press release,[7] the ATO was required to release a discussion paper suggesting that the 'effective life' for depreciation purposes of new tractors be increased to 12 years; and to 10 to 12 years for new harvesters.

2.24 The amendments in the bill add a statutory cap of $6^2/_3$ years to the uniform capital allowances regime for tractors and harvesters used in the primary production sector, thus preserving the current $6^2/_3$ year period and ensuring that there will be no change to the income tax treatment on harvesters and tractors. The measure is intended to provide certainty to farmers in a time of drought.[8]

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6 *Review of Business Taxation, A tax system redesigned*, July 1999.

7 *Farmers to be protected from changes to the 'effective life' of tractors and harvesters*, Minister for Revenue and the Assistant Treasurer, the Hon. Peter Dutton, MP, Press Release No. 083, 16 November 2006.

8 *Government to make further improvements to the tax system*, Minister for Revenue and the Assistant Treasurer, the Hon. Peter Dutton, MP, Press Release No. 091, 7 December 2006.

## Schedule 6—Farm management deposits

2.25 Schedule 6 is another measure to support primary producers through the ongoing drought.[9] It increases the non-primary production income threshold from $50,000 to $65,000 per income year and the total amount that a primary producer can hold in a farm management deposit from $300,000 to $400,000.

2.26 Primary producers (with a limited amount of non-primary production income) can claim deductions for farm management deposits made in the year of deposit. When they withdraw a farm management deposit, the amount of the deduction previously allowed is included in assessable income in the withdrawal tax year. The scheme is designed to allow primary producers to set aside income from profitable years for subsequent 'draw-down' in low-income years, thus reducing the risk of income variability owing to factors such as drought.

2.27 Currently, an individual primary producer with taxable non-primary production income of $50,000 or less for the year of income is able to make a farm management deposit. By increasing the non-primary production income threshold from $50,000 to $65,000 the amendment will allow more primary producers to hold farm management deposits as well as allow current holders to earn a larger amount of non-primary production income each income year without becoming ineligible for the Scheme.

## Schedule 7—Capital protected borrowings

2.28 The measures in Schedule 7 deal with the taxation of capital protected borrowings (CPBs). They amend the *Income Tax Amendment Act 1997* (ITAA 1997) to overcome the decision of the Full Federal Court in Firth's Case[10] where the Court ruled that the component of 'interest' applicable to the cost of capital protection feature of a capital protected borrowing (CPB) is deductible when paid. On 5 November 2002, the High Court refused special leave for the Commissioner of Taxation to appeal this decision.

### *Context of amendments*

2.29 A typical CPB is a limited recourse loan facility which is used to fund the purchase of shares, units or stapled securities. The nature of the facility is such that the borrower has the right to satisfy the outstanding loan by transferring the shares, units in a unit trust or stapled securities back to the lender. Consequently, the borrower is protected if there is a fall in the price of the shares, units in a unit trust or stapled securities acquired under the loan facility. According to the Explanatory

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9 *Government to make further improvements to the tax system*, Minister for Revenue and the Assistant Treasurer, the Hon. Peter Dutton, MP, Press Release No. 091, 7 December 2006.

10 *Commissioner of Taxation vs Firth* 120 FCR 450.

Memorandum, such an arrangement can be viewed as, or disaggregated into, a full recourse loan and an embedded put option.

2.30 The cost of the capital protection component is included in, and takes the form of, 'interest' payable on the loan. As a result, the total 'periodic' expense (labelled 'interest') paid by the holder of a CPB may be considerably higher than the interest payable on a borrowing facility without capital protection.

2.31 Another common type of CPB involves a full recourse loan to fund the purchase of shares, units or stapled securities and an explicit put option to hedge the value of the securities.

*Firth's case*

2.32 The CPB in Firth's case consisted of:

- a limited recourse loan made to acquire a beneficial interest in the underlying securities, which could be satisfied by putting the securities to the lender; and
- the borrower's beneficial interest in the underlying securities.

2.33 Interest incurred on the limited recourse loan used to purchase securities may be deductible in accordance with section 8-1 of the ITAA 1997.

2.34 Any income from the underlying securities acquired by the funding under the loan is usually subject to tax, as is any capital gain on disposal of the underlying securities. Any capital loss on disposal will be subject to the quarantine provision of the capital gains tax (CGT) provisions meaning that it could only be offset against a capital gain.

2.35 The decision in Firth's case allows a borrower to obtain an income tax deduction for what may in fact be, in substance, a capital cost.

2.36 The measure in the bill will treat capital protection under a CPB that is not provided under an explicit put option as though it is a put option that is acquired by the borrower under the CPB. It will also treat the amount incurred in respect of such capital protection as though it is a put option premium paid by the borrower under the CPB to the provider of the capital protection under the CPB. The measure will also apply to CPBs with explicit put options.

***Standing Committee for the Scrutiny of Bills comment***

2.37 In its Alert Digest No. 1 of 2007, the Scrutiny of Bills Committee raised the issue of retrospective application in relation to Schedule 7, item 5. The retrospectivity arises because the amendments to overcome the effect of the Firth case are to apply from the date of the Treasurer's press release, issued on 16 April 2003 which announced the Government's decision.

2.38 The Scrutiny of Bills Committee drew attention to a declaratory resolution of the Senate in 1988 to the effect that if more than six months elapses between a government announcement of a taxation proposal and the introduction or publication of a bill, the Senate will amend the bill to reduce the period of retrospectivity to the time since the introduction or publication of the bill.

# 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 <u>will</u> fall under the exemption from IWT in the sections, as well as the circumstances under which the interest paid by a company or trustee <u>will not</u> 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

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**

# Additional Remarks by Labor and Democrat Senators

We the undersigned Senators support the Bill as a whole with the exception of Schedule 2. The Bill should be split with Schedule 2 of the Bill to be considered at a later time, but before the end of the financial year.

The undersigned Senators are concerned that Schedule 2 may seriously inhibit Australian firms' ability to raise cost effective finance. As evidenced by the submissions, there are concerns that the amendments may particularly affect Australian firms' ability to participate in syndicated loans. As noted in the ABA's submission, "the Bill will unreasonably impede access by borrowers to international debt markets"… "the proposed amendments will prejudice the ability of Australian firms to participate in the syndicated loan market".[1]

The submissions also raised concerns that significant compliance costs would be imposed on business as a result of schedule 2. AFMA's submission notes that "the regulation impact statement describes the compliance costs as negligible. However, this is not consistent with the feedback we have from a number of firms".[2] The compliance costs arise from the uncertainty created in the loan market by schedule 2. The legislation creates significant uncertainty in the market as to which types of financial instruments are eligible for the withholding tax exemption. The proposed regulation making power to exclude debentures and to include debt interests creates this uncertainty. APLMA's submission explains that the failure to issue regulations concurrently with the introduction of the Bill introduces uncertainty into an issue regarded as settled ie: that debentures qualify for the exemption.[3]

The inquiry also highlighted that the Bill may have retrospective application. ABA's submission stated that "the Bill will be retrospective and will effectively impose costs (via interest withholding tax "gross up" clauses) on Australian borrowers who negotiated loan agreements in good faith based on current law".[4] There is a need for transitional rules, as stated by the ICCA submission to ensure that certain financial instruments currently used by Australian borrowers are not negatively affected.[5]

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

2 Australian Financial Markets Association, *Submission 4*, p. 3.

3 Asia Pacific Loan Markets Association, *Submission 3*, attachment, p. 3.

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

5 Institute of Chartered Accountants in Australia, *Submission 2*, p. 4.

The problems with the legislation stem from the Government's failure to adequately consult with key stakeholders. As the ABA noted in its submission "a breakdown occurred in the consultation process in relation to the IWT amendments".[6]

We believe that the proposed schedule 2 substantially reverses the changes made by the Parliament in 2005, and we do not believe the Government has yet made a case to do so. As a minimum, we believe that schedule 2 of the Bill should be withdrawn until the regulations that would accompany the Bill in the first instance are ready. However, we also believe that the Government should seriously consider further consulting with industry with a view to giving Treasury the power to prescribe financial instruments which will not receive the withholding tax exemption rather than those that will.

**Recommendation**

**The undersigned Senators recommend that:**

- **as a minimum, the Bill be split with schedule 2 of the Bill to be considered at a later time once the legislation or once the regulations that will accompany the legislation are completed. Further, the Government should amend schedule 2 to give Treasury by regulation, the power to prescribe financial instruments which will not receive the withholding tax exemption rather than those that will.**
- **the Senate pass the remainder of the Bill (schedules 1 and schedules 3 to 7).**
- **Schedule 2 be dealt with before the end of the 2006-07 financial year.**

Senator Ursula Stephens
**Deputy Chair**

Senator Ruth Webber

Senator Andrew Murray

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

# APPENDIX 1

## Submissions Received

| Submission Number | Submitter |
|---|---|
| 1 | Australian Bankers' Association Inc (ABA) |
| 2 | The Institute of Chartered Accountants in Australia (ICAA) |
| 3 | Asia Pacific Loan Market Association Limited (APLMA) |
| 4 | Australian Financial Markets Association (AFMA) |
| 5 | Dr Mark Burton |

# APPENDIX 2

## Public Hearing and Witnesses

**Monday, 26 February 2007 – Canberra**

BAXTER, Mr Duncan, Member, National Tax Technical Committee
Institute of Chartered Accountants in Australia (ICAA)

BURKE, Mr Anthony John, Director
Australian Bankers' Association (ABA)

GREEN, Mr Wayne Robert John, Chairman, Australian Branch
Asia Pacific Loan Market Association (APLMA)

LADUZKO, Mrs Josephine Anne, Manager, International Tax Unit
Department of the Treasury

LATHAM, Mr Craig Ian, Acting Assistant Commissioner
Australian Taxation Office (ATO)

MILLER, Mr Greg, Executive Director, ANZ Investment Bank
Member, Asia Pacific Loan Market Association (APLMA)

NOROOZI, Mr Ali, Tax Counsel
Institute of Chartered Accountants in Australia (ICAA)

PITTARD, Mr Ian, Manager
Australian Taxation Office (ATO)

RAWSTRON, Mr Michael Brian, General Manager, International Tax and Treaties
Division, Department of the Treasury

# APPENDIX 3

## Response to questions on notice taken by Treasury

**Financial Impact**

The interest withholding tax amendments currently before Parliament will have a nil cost against the forward estimates. This is because the amendments merely correct unintended consequences, which had not been widely exploited or endorsed by an ATO private ruling.

There would have been a substantial revenue risk if the unintended consequences were not corrected and taxpayers were to take advantage of them by acting according to the letter of the law.

**CGT and Tax Treaties**

Most Australian post-CGT treaties allow each country to tax, according to its domestic law, any capital gains derived by its own residents or by a resident of the other country from the alienation of shares. However, the recently signed treaties with France, Norway and Finland will, once in force, only allow the country of residence to tax such gains (other than gains from 'land rich' entities). Thus France , for example , will not be able to tax gains made by an Australian resident from the sale of shares in a French company (other than gains from 'land rich' entities).