The Institute of Chartered Accountants in Australia

16 February 2007

BY EMAIL

Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

Email: economics.sen@aph.gov.au

Dear Sir,

Inquiry into the provisions of the *Tax Laws Amendment (2006 Measures No. 7) Bill 2006*

We appreciate the opportunity to make this submission on *Tax Laws Amendment (2006 Measures No. 7) Bill 2006.* Our submission is limited to the proposed amendments to the interest withholding tax exemptions in sections 128F and 128FA of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936). These amendments are contained in Schedule 2 to the *Tax Laws Amendment (2006 Measures No.7) Bill 2006,* which is presently before the Senate.

The Institute of Chartered Accountants in Australia (the **Institute)** is Australia's premier accounting body, which represents over 44,000 members who are fully qualified Chartered Accountants working either in the accounting profession providing auditing, accountancy, taxation and business consultancy services or in diverse roles in business, commerce, academia or government.

Background

The interest withholding tax exemption in ss.128F & 128FA of the ITAA 1936 (the **IWT exemption**) was introduced in recognition of the commercial reality that many foreign lenders do not bear the cost of this tax. Instead, the foreign lender is often able to insist that the Australian borrower increases, or "grosses-up", the interest payments to ensure that the foreign lender receives the same amount of after-tax interest income. In these situations, the Australian borrower effectively bears the cost of the interest withholding tax.

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The second reading speech to the legislation that introduced the IWT exemption clearly articulates this policy basis:[1]

> When the interest withholding tax in its current form was introduced as from the beginning of 1968, it was expected that in most cases, particularly where there were arrangements between Australia and the other country concerned for relief of double taxation, the overseas lender would be able to obtain a taxation credit in his own country for interest withholding tax deducted in Australia. If so, it was to be expected that the burden of the Australian interest withholding tax would not generally fall on the Australian borrower - in other words, that the rate of interest payable by the Australian borrower would not include the cost of interest withholding tax.
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> However, a review of the effect of the interest withholding tax on Australian borrowers has caused the Government to believe that the tax frequently falls, not on the overseas lender, but on the Australian borrower. This is because the lender adds to the rate of interest he charges as compensation for the interest tax withheld.

The IWT exemption originally applied only to bearer debentures, but its scope has been expanded over the years to accommodate changes in global financial markets. In 2001 the Federal Government introduced new rules to distinguish between "debt interests" and "equity interests" for tax purposes (**Debt/Equity Rules**).[2] The Debt/Equity Rules responded to the increasing use of so-called "hybrid instruments" which were legally equity but in-substance debt (eg. redeemable preference shares), or legally debt but in-substance equity (eg. perpetual notes). These rules were intended to improve the operation of capital markets by distinguishing between debt interests and equity interests, for tax purposes, on the basis of their **substance**, rather than their legal **form**:[3]

> **Economic benefits**
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> The New Business Tax System will provide Australia with an internationally competitive business tax system that will create the environment for achieving higher economic growth, more jobs and improved savings. The economic benefits of these measures are explained in more detail in the publications of the Review of Business Taxation, particularly A Platform for Consultation and A Tax System Redesigned.
>
> The measures in this bill will contribute to these broader economic goals by reducing uncertainty, improving the integrity of the tax system and helping to provide a sustainable revenue base. The debt/equity rules facilitate the effective pricing of financial arrangements through more coherent taxation laws improving the operation of the capital markets.

The Debt/Equity Rules essentially provide that the return on a "debt interest" is deductible to the issuer and fully assessable to the holder. Conversely, the return on an "equity interest" is not deductible to the issuer but may be "franked", and although still assessable to the holder, may carry a franking credit under the dividend imputation rules.

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1 Refer to the second reading speech to the *Income Tax Assessment Bill (No. 2) 1971* (Cth) (the **1971 Bill**).

2 Refer generally to Div.974 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA1997**).

3 Refer to paragraphs 5.35 and 5.36 of the explanatory memorandum to the *New Business Tax System (Debt and Equity) Bill 2001* (Cth).

In 2005 the Federal Government updated the IWT exemption to accommodate the Debt/Equity Rules. In particular, the scope of the IWT exemption was expanded to cover "debt interests" more generally, rather than just "debentures". This change harmonised the withholding tax treatment of debt interests and, to that extent, was entirely consistent with the policy basis for the Debt/Equity Rules themselves:[4]

> While the concept of interest in the IWT provisions was partially aligned with the new debt/equity rules in 2001, the concepts of 'debenture' and 'offshore borrowing' need to be similarly updated to make the IWT provisions work as intended.

We understand that the Australian Taxation Office (**ATO**) and the Department of Treasury, are concerned that the 2005 update may have inadvertently expanded the scope of the IWT exemption too widely. In particular, the ATO and Treasury are apparently concerned that interest on some "term deposits and other standard bank accounts" (ie. retail bank deposits) may qualify for the exemption inappropriately. It is implicit in their concerns that the policy basis for the IWT exemption would not justify its extension to retail bank deposits because the foreign depositor, rather than the Australian bank, would normally bear the cost of any interest withholding tax. The proposed amendments are intended to confine the scope of the IWT exemption so that it excludes, in particular, bank deposits. However, the Institute has serious concerns about a number of aspects of the amendments. We set out these concerns below.

Submission

1. The proposed amendments include a power to make regulations that exclude particular "debt interests" from the IWT exemption.[5] This power applies to debentures as well as debt interests to which the 2005 update applied. We submit that there is no policy need to suddenly exclude particular debentures from the exemption.

2. The proposed amendments only include "debt interests" (other than debentures) in the IWT exemption if they are also "non-equity shares" (that is, financial instruments that are legally equity but in substance debt).[6] The amendments merely make provision for extending the scope of the IWT exemption, by regulation, to financial instruments that are legally **and** in substance debt but which are not "debentures".[7] In our submission, there is no policy basis for generally excluding such instruments from the exemption, merely because they are not "debentures".

3. We acknowledge that there may be policy grounds for excluding retail bank deposits from the IWT exemption. However, we submit that this could be more efficiently achieved by excluding "debt interests" that meet all three of the following conditions:

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4 Refer to paragraph 3.3 of the explanatory memorandum to the *New International Tax Arrangements (Managed Funds and Other Measures) Bill 2004* (Cth).

5 Refer to proposed ss.128F(1C) & 128FA(2A).

6 Refer to proposed ss.128F(1)(f)(i), 128F(1A)(e)(i), 128F(1B)(c)(i), 128FA(1)(b)(i) & 128FA(2)(c)(i).

7 Refer to proposed ss.128F(1)(f)(ii), 128F(1A)(e)(ii), 128F(1B)(c)(ii), 128FA(1)(b)(ii) & 128FA(2)(c)(ii).

(a) the debt interest is a “deposit product” within the meaning of s.764A(1)(i) of the *Financial Services Reform Act 2001* (Cth) (**FSRA**);

(b) the debt interest was issued to a “retail client” within the meaning of s.761G of the FSRA; and

(c) the debt interest is not a “debenture”.

4. We are not aware of any other financial instruments in respect of which the ATO and Treasury have similar concerns, and therefore for which there might be similar policy grounds for an exclusion from the IWT exemption. Accordingly, we submit that there is no need for any other exclusions.

5. For the same reason, we submit that there is no need for a power to make regulations that exclude particular instruments from the exemption.[8]

6. Irrespective of whether the above submissions are accepted, we submit that there is a need to ensure that the transitional rules in the proposed amendments preserve the existing treatment for:

   (a) Debt interests issued under a facility to which an issuer was committed, but under which it had not yet issued any interests, on the operative date (“committed facilities”);

   (b) Further debt interests issued under a facility to which an issuer was committed, and under which it had issued some of (but not all) the interests, on the operative date (“staggered draws”);

   (c) Debt interests issued under a facility to which an issuer was committed on the operative date, where some or all of those interests are subsequently redeemed and new interests issued under the same facility (“redraws”);

   (d) Debt interests issued under a facility to which an issuer was committed on the operative date, where some or all of those interests are subsequently “rolled over” by redemption and the issue of new interests under the original facility (“rollovers”);

   (e) Debt interests that are assigned by novation of an existing facility (“novations”); and

   (f) Debt interests issued under a facility that is varied (other than in respect of its fundamental terms and conditions) on or after the operative date (“minor variations”).

   The proposed transitional rules only preserve the existing treatment for debt interests that were issued before the operative date. We submit that the transitional rules should preserve the existing treatment for debt interests, **and facilities**, to which the issuer was committed on the operative date.

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[8] Refer to proposed ss.128F(1C) & 128FA(2A).

7. If our submission at 5 above is not accepted, then we submit that similar transitional rules should apply to any power to make regulations that exclude particular instruments from the exemption.

Representatives of the Institute participated in a meeting with Treasury officers on 15 February 2007 to discuss the proposed amendments. We put the above submissions to Treasury and continue to be engaged in their consultation process.

Please do not hesitate to contact the Institute's Tax Counsel, Mr Ali Noroozi on (02) 9290 5623 if you have any queries in relation to the above.

Yours sincerely,

Graham Meyer
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Institute of Chartered Accountants in Australia