AFMA

16 February 2007

Mr Peter Hallahan
Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Mr Hallahan

Tax Laws Amendment (2006 Measures No.7) Bill 2006 –
Interest Withholding Tax

The Australian Financial Markets Association (AFMA) represents participants in the Australian wholesale banking and financial markets, which includes Australian and foreign-owned banks, financial institutions and companies with a significant interest in the over-the-counter markets.

I am writing to you on behalf of AFMA in response to the Committee's inquiry into the amendments in Schedule 2 of the Bill, which 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. Members are concerned about effect of the measures on financial markets, especially their retrospective impact on the syndicated loan market, and believe amendments to the Bill are required to provide a more reasonable outcome.

Preserving the Policy Direction and Benefits

The scope of interest withholding tax relief available to business has been gradually extended over the last decade through amendments to both our domestic tax law and our international tax treaties.

In domestic tax law, the Government has expanded the range of borrowings eligible for s.128F relief on a number of occasions - for example, by removing the business end-use requirement in 1997, making s.128F funds available to foreign branch banks in 2001 and extending relief to debt interests in 2005.

On the international front, the revised US and UK tax treaties significantly expand the scope of interest withholding tax relief available in respect of borrowings from financial institutions. This relief is being extended to other most favoured nation jurisdictions through the ongoing renegotiation of tax treaties.

This 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. Therefore, we believe any amendments should be carefully considered and targeted specifically to address a proven weakness in the current law. Moreover, the measures should recognise the nature of developed financial markets and not impose an unnecessary compliance cost burden on borrowers.

Better Directed Amendments

Schedule 2 of the Bill is evidently based on a perceived need to contain a tax revenue risk. While we understand the need to preserve the tax base in order to support government services to the community, we believe it is possible to effectively manage proven tax revenue risk and substantially preserve consistency in the policy direction by introducing measures that are better targeted at the matters of concern to the tax authorities.

In particular, we believe the legislation would be more certain in effect if it were designed to retain the withholding tax exemption for all debentures and debt interests, except those debt interests excluded by regulations. In addition, there should be clear principles based on the policy underpinning s.128F to guide the formulation of the associated regulations, so the law delivers a consistent and fair outcome for taxpayers. We do not believe this quality of outcome can be achieved by regulations made under the Bill in its current form.

Reasons to Adopt the Alternative Approach

The Bill proposes mechanisms to remove the interest withholding tax exemption for non-debenture debt interests (apart from non-equity shares) unless they are expressly included by regulation. This approach would undermine the principle of tax neutrality across economically similar products that is a feature of the current law, so it would be a retrograde step.

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.

This inclusive approach to the s.128F interest withholding tax exemption should be preserved going forward to the greatest extent possible, while respecting any legitimate concerns about risk to tax revenue. This could be achieved by recasting the provisions in the Bill so that regulations are used only to exclude specified arrangements that are shown to create an unwarranted revenue risk within the framework of the underlying policy. In this way, the basis for a regulation would be transparent and open to review, reducing the risk of unnecessary regulations and unintended outcomes.

It is a matter of particular importance for members that arrangements documented as syndicated loan facilities, and are a debt interest, remain eligible for s.128F relief. Members have also observed that the provisions in Schedule 2 will have a retrospective effect on syndicated loans facilities arranged prior to the introduction of the Bill but will have amounts drawn down after the Bill was introduced. Obviously, this is concerning but we understand it is an unintended outcome and we are hopeful that it will be corrected.

The Bill also proposes a mechanism to exclude arrangements that might otherwise be eligible debentures for the purpose of s.128F.[1] Until the Bill was introduced, it had been certain that all debentures and debt interests are eligible for s.128F relief. Now 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. Thus, the law will introduce uncertainty and will generate additional compliance costs.

[1] Proposed sections 128F(1C) and 128FA(2A).

This concern is exacerbated by the absence of clear principles to govern the application of the regulations to particular arrangements. The EM (eg paragraph 2.11) suggests that the regulations will be made by reference to an undefined concept that in effect reflects what a "traditionally" exempt debenture might be. This approach would not give the desired "clearer guidance to the market".

We are unaware of a problem with the current definition of debenture for the purpose of s.128F, but if there is a concern in this area it should have been properly explored through consultation. This would have tested the validity of the concerns and the process would also have informed industry of the practical issues that might concern the tax authorities.

The regulation impact statement describes the compliance cost impact of the measures as "negligible". However, this is not consistent with the feedback we have from member firms, who have commented on the greater uncertainty and the potential need to document arrangements in a revised form, without altering their substance.

Concluding Comments

In summary, we believe that Schedule 2 of the Bill must be amended to achieve its stated objective in a manner that does not impose an unnecessary regulatory burden on business. We have recently been involved in useful discussions with the Department of Treasury who are considering these issues. The Committee could play a constructive role in promoting refinements to Schedule 2 to achieve a better outcome for business.

Thank you for your kind attention to the concerns that we have raised.

Yours sincerely

Duncan Fairweather.

Duncan Fairweather
Executive Director