

Chapter 4

Schedule 3—interest withholding tax, extension of eligibility for exemption to state government bonds

4.1 Schedule 3 to this bill amends section 128F of the *Income Tax Assessment Act 1936* (ITAA 1936) to allow bonds issued in Australia by state and territory central borrowing authorities to be eligible for exemption from interest withholding tax (IWT).

4.2 The schedule extends the eligibility for exemption from IWT to bonds issued in Australia by state and territory central borrowing authorities (semi-government bonds).

4.3 The proposed amendment represents the implementation of a policy announced by the Treasurer on 14 May 2008.

Background

4.4 IWT is imposed on the payment of interest from Australia to non-residents, at a rate of 10 per cent of the gross amount of interest. The obligation for collecting (withholding) the IWT is on the person making the payment (i.e. the borrower).

4.5 Section 128F of the *ITAA 1936* provides that where an Australian resident company, or a non-resident company carrying on business at or through a permanent establishment in Australia, issues a debenture or certain specified debt instruments and the issue satisfies the public offer test, an exemption from IWT will apply.

4.6 In 1999, the requirement that these debentures be issued outside Australia was removed for most borrowers. However, the liberalisation was not extended to the state central borrowing authorities. As a consequence, the interest paid to non-residents on bonds issued in Australia by state central borrowing authorities is liable to IWT (unless exempt under a treaty or another arrangement).

4.7 Consequently, the state central borrowing authorities have continued to issue their bonds offshore to remove the liability to IWT and attract non-resident investors.

4.8 Because of the state central borrowing authorities' concerns—that this practice had resulted in a segmented market, reduced liquidity and efficiency, and hampered the role of the state government bond market—the Federal Government announced its decision to extend eligibility for exemption from IWT to domestically issued state government bonds.

Proposed amendments

4.9 Submitters to the inquiry were supportive of the arrangements to remove interest withholding tax from semi-government bonds.

4.10 Arguing that 'the Commonwealth IWT on domestic semi government bonds is counterproductive to the development of an improved financial system', the New South Wales Treasury Corporation (TCorp) claimed that it will correct the disadvantage that affected the states after 1999.¹

4.11 TCorp submitted that the 1999 decision not to extend the liberalisation to state central borrowing authorities resulted in:

- fragmenting the semi government bond market;
- reducing liquidity in semi government bonds;
- raising the cost of borrowing by Australian State governments;
- creating inefficiencies in financial markets that raise the total cost of capital in Australia;
- discouraging international bond investors from allocating money to Australia; and
- raising almost no revenue for the Commonwealth.²

4.12 TCorp believes that the abolition of IWF on these bonds will increase state government liquidity and help to finance—and lower the costs of—major infrastructure projects, projects that will in turn boost Australia's long-term productivity and export capacity. In addition, TCorp argues that the proposed changes have the potential to lower borrowing costs for all bond issuers while having no negative consequences for Commonwealth revenue.

4.13 The Australian Financial Market Association (AFMA) also supports this measure, believing that the changes 'are well-timed to assist debt market development, improve the efficiency of the fund raising process for states and facilitate innovation in debt security offerings to investors'.³ AFMA also agreed with TCorp that Schedule 3 would allow for greater flexibility in funding infrastructure investment.

1 Queensland and New South Wales are the two largest semi-government issuers. Between them they have over \$29bn of global exchangeable bonds on issue, and \$38bn of domestic bonds outstanding. New South Wales Treasury Corporation, *Submission 5*, p. 2.

2 New South Wales Treasury Corporation, *Submission 5*, p. 1.

3 Australian Financial Market Association, *Submission 4*, p. 1.

4.14 TCorp and AFMA both supported the reform because it would unify the offshore and domestic semi-government bond market. Unification, they contend, would strengthen Australia's presence in the global bond market, increase liquidity and lower the cost of borrowing.⁴ In evidence to the committee AFMA stated:

The measures in Schedule 3 of the bill will enable unification of the domestic and offshore segments into a single market...It will add liquidity and depth to the domestic market. The associated benefits include a larger and more diverse market for investors, greater product innovation and a more effective state government yield curve. In essence, it will also strengthen Australia's presence in the global bond market indices and enhance our standing as an international financial centre.⁵

4.15 In evidence provided to the committee, TCorp also suggested that the proposed changes would assist Australian markets survive the current instability in international financial markets:

...given the challenges of the current global crisis, I think it makes this initiative even more important in terms of its improvement of market efficiency and improved liquidity of markets at a time when markets are challenged.⁶

4.16 One submission received by the committee expressed concern about the effect of the proposed legislation on the authorities of the Commonwealth. This submission contends that because the amendments to section 128F do not extend to them, such authorities remain disadvantaged by the proposed legislation.⁷ The submitter therefore recommended that the government consider extending the proposed amendment to include authorities of the Commonwealth 'so as to ensure that these authorities can operate on a level playing field with their commercial counterparts'.⁸

4 Australian Financial Market Association, *Submission 4*, p. 2; Mr David Lynch, Australian Financial Markets Association, *Proof Committee Hansard*, 28 October 2008, p. 11.

5 Mr David Lynch, Australian Financial Markets Association, *Proof Committee Hansard*, 28 October 2008, p. 11.

6 Mr Stephen Knight, New South Wales Treasury Corporation, *Proof Committee Hansard*, 28 October 2008, p. 13.

7 *Submission 1* (Confidential), p. 2.

8 *Submission 1* (Confidential), p. 2.