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Dear Sir/Madam

Australia's Future Tax System- Consultation Paper

The Australian Financial Markets Association (AFMA) welcomes the opportunity to submit comments on the Consultation Paper issued by the review last December. AFMA is the peak industry body representing participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign banks, securities companies, fund managers, energy traders and other specialised markets and industry service providers.

We have focussed our comments on the policy issues relevant to the taxation of business and investment. Section 1 of our submission focuses on the tax structure, most notably interest withholding tax. Section 2 considers two aspects of the tax policy development and administration processes.

1. Tax Structure – Business and Investment

1.1. Interest Withholding Tax on Financial Intermediaries

Policy Background

Chapter 6 of the Consultation Paper asks if the tax system can be structured to better attract investment to Australia in a way that increases national income, and if so how?

This question brings into play an important issue because Australia relies on foreign capital inflows. To maintain macroeconomic balance, Australia must raise significant amounts of capital overseas to finance the balance of payments (an annual current account deficit in recent years of over 5.5% of GDP or in excess of \$55billion).

Financial intermediaries play a vital role in financing the current account deficit by raising funds overseas to on-lend to Australian business and by arranging and

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underwriting the issuance of securities by Australian companies in overseas markets. Thus, from a macroeconomic perspective it is highly desirable that the tax system does help to attract investment into Australia, or at least does not present a barrier to it. Interest withholding tax is relevant in this regard as it places an additional cost on, and is an impediment to, overseas funding by financial intermediaries.

The Consultation Paper also asks can the tax system be restructured to improve resource allocation within the economy and minimise operating costs, and if so, how?

We note that while increasing the amount of capital available to business is an important input to economic development, the role of financial intermediaries in increasing the value extracted from the capital that is available is even more important (ie the efficiency of capital allocation and usage is important). Greater cost for credit and restrictions in the flow and availability of finance impede the switching of capital resources from one use to another. Cost sensitivity is greatest in the wholesale lending market, where margins are much narrower than in the retail market and less able to absorb interest withholding tax expense. It is especially important in the current economic and financial climate that taxation impedes the financial intermediation process to the least extent possible. This situation also supports reform to the current interest withholding tax arrangements to alleviate the cost burden on business.

In addition, there is a range of other Government policies that would benefit from a liberalisation of the interest withholding tax regime:

- *Competition Benefits* – Smoother access to international debt markets would enable a broad range of Australian based financial intermediaries to fund their business in a cost effective manner and support competition within the Australian banking and financial markets. This would benefit Australian business and the broader community, including retail borrowers, by reducing the cost of investment funding. Benefits include more innovative funding arrangements, lower tax compliance costs and less tax uncertainty.
- *Systemic Risk Reduction* - Foreign banks have developed a significant presence in the Australian financial system, reducing systemic risk by providing diversification in our financial institutions and markets. Interest withholding tax reform would support this.
- *International Financial Hub* – Interest withholding tax makes Australia a less attractive place for international banks to do business and impedes the Government's objective of promoting Australia as a global financial centre. For example, banks use branches to conduct their international business operations on a seamless basis but withholding tax introduces a break for the purpose of managing liquidity and funding. The reforms proposed below would make Australia more tax competitive and enable banks to bring more business to here (eg through regional liquidity management opportunities).
- *Taxation Policy* - International tax reform is orientated towards the elimination of interest withholding tax, as reflected in revisions to international tax treaties and

measures by individual jurisdictions (eg Canada eliminated non-resident interest withholding tax in 2008). More generally, tax efficiency and equity principles would be better served by the measures proposed.

Current Tax Position

Australian sourced interest paid or credited to non-residents is subject to the interest withholding tax provisions in the Tax Act.¹ In effect, these provisions provide that the recipient of Australian sourced interest is subject to withholding tax on the gross amount paid or credited. A rate of 10% of the gross amount of the interest is imposed and the obligation for collecting the withholding is placed on the person making the payment. Thus, in effect, the cost of withholding tax falls on the borrower in wholesale markets. If the borrower is a financial intermediary, the cost is generally passed on to its clients so, one way or another, the cost of withholding tax falls on Australian business.

There are a number of important exemptions to interest withholding tax that are heavily utilised by financial intermediaries and corporates, the most notable of which are:

- Section 128F exemption for publicly offered debentures and syndicated loans by Australian entities (including government bond issues offshore);
- Tax relief through double tax agreements (notably through renegotiated agreements with the United States and the United Kingdom) in respect of borrowing from financial intermediaries in the other jurisdiction and interest derived by a government body of the other jurisdiction;
- Australia adopting the international practice of not taxing sovereign governments on income from their passive investments in Australia.²

However, there are gaps in the interest withholding tax relief that is available to financial intermediaries that are problematic from the perspective of attracting investment funds into Australia and the efficiency of our markets. These include:

- Foreign bank branches must pay interest withholding tax on funding from their overseas parent bank (at a rate of 5%), which makes this funding uncompetitive and closes off this as a significant avenue for bringing capital into Australia;
- Financial intermediaries that borrow from related parties overseas must pay withholding tax at 10% on the associated interest payments, which also presents a barrier to debt capital injections into Australia through this mechanism;
- Financial intermediaries in Australia must pay 10% withholding tax on wholesale deposit funding in overseas markets, which effectively prevents large scale funding through this mechanism.

¹ Division 11A of Part III of the Income Tax Assessment Act 1936.

² For example, see ATO ID 2002/45.

The adverse impact of these measures on financial intermediaries has been exacerbated by the impact of the global financial crisis, which has restricted the availability of credit on economic terms in the Australian market, forcing some entities to rely on parent funding as an interim measure. Less credit is available to Australian business and it comes at a greater cost. In other cases, banks are unable to access the international wholesale deposit market on economic terms due to the imposition of interest withholding cost. Moreover, there is a more general question about the merit of retaining interest withholding tax for financial intermediaries and incurring the associated compliance costs in addition to the funding constraint.

Proposed Reforms

In view of the above, AFMA proposes that the Review should recommend that interest withholding should be removed from financial intermediaries' borrowing from non-residents as a long term tax reform measure.

The tax base for interest withholding tax has been narrowed over the last decade, especially through an expansion of s.128F relief and renegotiation of double tax agreements. Therefore, the tax cost to granting more comprehensive interest withholding tax relief has declined over this period and is likely to be further reduced as additional tax treaties are renegotiated. A further offset will be tax revenue generated from greater business activity that is expected to flow from this tax reform; for example, through a greater inflow of funds to Australia.

Moreover, while the existing tax exemptions, like s.128F relief, are highly valued; they do not reduce compliance costs to the extent that would be economically desirable, as companies wishing to utilise the relief must weave through the rules (very carefully, given the cost of non-compliance) and ATO must enforce the rules. The complete abolition of interest withholding tax for financial intermediaries would generate compliance cost benefits for financial intermediaries and for the ATO, which would further mitigate the tax revenue foregone.

Tax revenue in respect of the remainder of the interest withholding tax base (e.g. interest payments on domestic Commonwealth government bonds) would be unchanged, so a significant tax base would remain in place.

The existing law contains significant measures to curtail the risk of profit shifting alluded to in the Consultation Paper. In particular, transfer pricing rules that apply as a matter of course to common financial transactions (including lending, foreign exchange and derivatives) and the thin capitalisation regime (comprehensively revamped in 2001) are important safeguards in this area. They are complemented by new taxation of financial arrangements law that better aligns economic and tax performance, as well as regulatory and governance arrangements that separately measure and assess (and for commercial purposes reward) the performance of financial intermediaries in Australia.

We note there is broad industry support for additional withholding tax relief for financial intermediaries. The Australian Bankers' Association (ABA) has called for an exemption from interest withholding tax for funds raised from non-residents by Australian based financial institution groups, including Australian branches of foreign banks. ABA is strongly of the view that the proposed exemption does not require a general related party exception.

Having regard to current difficult market conditions for funding business credit and potentially a need for the Review to establish priorities or adopt a graduated approach to change, we propose the following measures should be adopted as an immediate priority and implemented as soon as possible:

- Abolition of interest withholding tax on foreign parent to Australian branch funding – the revenue cost is very small (between \$5 and \$7 million) in an ordinary year³;
- Abolition of interest withholding tax on related party funding (from the foreign parent) to a financial intermediary subsidiary incorporated in Australia – there would be a revenue cost but the amount involved in normal conditions cannot be determined solely by reference to AFMA's members;
- Abolition of interest withholding tax on large size deposits – the revenue is expected to be small as the current withholding tax effectively prevents Australian banks tapping into this market to a significant extent.

The more comprehensive interest withholding relief for financial intermediaries proposed above could be implemented in accordance with the Review's general timetable for business tax measures.

1.2. Taxation of Widely Offered Financial Products

Australian government policy places a responsibility on individuals to accumulate wealth to meet their ongoing needs and provide for their welfare in retirement. This has contributed to significant demand from investors for a broad range of financial products to grow their savings, get access to capital market growth and manage the associated risk in keeping with their profile and individual risk preference. The public reasonably expects to be able to make investment and risk management decisions within the framework of tax rules that are certain and reasonable. Unfortunately, the tax system does not deliver this at present and investors are hampered by an uncertain and complex tax system.

The taxation of capital protected products is a prime example of this problem – tax rules to increase tax revenue were announced without a clear underlying tax policy basis for them, erroneous assumptions were made in making those rules, tax rulings have been

³ The tax revenue number is derived from a survey of foreign ADI members; data for 2006-07 are used to assess the amount of interest withholding tax paid on parent funding in an ordinary year (ie pre-credit crisis). Larger overseas parent funding has been necessary during the global financial crisis, which has temporarily increased annual withholding tax collections to an estimated \$25 million.

difficult to get at times and there have been numerous changes to the rules over the past decade, resulting in excessive taxpayer compliance costs. Moreover, when changes are required they can take a long time to be implemented simply because the necessary technical resources (eg for drafting law) are not made available in a timely manner.

The economic cost to investors of getting policy or its implementation wrong in this area can be significant. It can result in distortions to investment decision making (eg consequent to a measure announced in the 2008 Budget the current interest deduction rules deter investors from buying capital protection), lower investment returns and generate high compliance costs.

This situation can be improved by the Government adopting measures, such as:

- The Government should recognise the importance of widely offered investment products and provide the necessary resources to ensure the tax rules for their treatment are maintained in good order and any changes required are made without undue delay;
- Industry should be involved in the tax policy formulation process as soon as is practical. We accept there may be occasions when the Government needs to act quickly and without notice to close tax loop holes that emerge. However, this does not preclude a greater level of consultation in other instances when tax policy measures are being developed. Therefore, the predisposition of Treasury should be to seek industry input in the initial stages of the policy making process;
- In recognition of the importance of ATO product rulings for many widely offered products, ATO should support implementation of the law in a certain and even-handed manner by providing rulings on a timely basis (by reference to the current law only) and engaging industry early when it is considering matters or practices that may be of concern to it.

1.3. Corporate Tax Rate

In our previous submission to the Review, we gave reasons why a lower corporate tax rate might improve Australia's competitiveness and should be considered. We also note that a lower corporate tax rate would increase the attractiveness to Australia of foreign entities who only benefit from the imputation system to the extent that they can reduce withholding tax on dividends paid offshore. This approach would complement the Government's policy of promoting Australia as a regional financial services centre.

2. Tax Process

2.1. Tax Policy Development Process

An effective consultation process is an essential element in the design and implementation of tax law that achieves its policy purpose in a low cost manner. It follows that the conduct of the tax policy consultation process must be managed in a way that promotes a comprehensive exchange of views and information between

taxpayers and the Department of Treasury, as the agency responsible for advising on tax policy. Most tax consultation processes are highly effective and well managed, but this outcome is not achieved on every occasion due to the absence of clear protocols around the consultation process.

In our experience, greater clarity about the role expected of participants in the consultation process would help to achieve better outcomes. For example, policy discussions should be conducted in an open and frank manner, where taxpayers are able to explain the areas of law that create tax risk or operational problems for their business. This approach facilitates discussion of how tax policy or law might be modified to overcome these problems.

However, this outcome is less likely to be achieved if the consultation process involves ATO personnel who might also be involved in another capacity in client risk review or audit of the taxpayers in question. There are many grey areas in the law, so this situation inevitably creates compliance risk for taxpayers disclosing their concerns and, understandably, can diminish the quality of the consultation process. There are a number of ways in which this problem might be addressed; for example, ATO could create an internal unit to support the policy development process that is at arms length from officers involved in compliance activity in the field but can leverage off the experience of field officers in a manner that respects the privilege of information provided in the consultation process.

It would be constructive to set out the nature of the contribution expected of participants in the consultation process, including Treasury, ATO and industry. Each has a responsibility to bring certain information and expertise to the table; Treasury is responsible for policy and tax design advice, industry must provide insights into the economic and commercial effect of the policy measures under consideration and ATO should advise on matters that arise in relation to the administration of the law. The consultation process should then be managed to include participants on a needs basis and delineate the contributions, so it minimises the demand placed on participants and promotes effective outcomes.

We note that Treasury's involvement in the formulation and management of tax policy is very important. It requires a combination of specialist expertise and a general policy management capability that can provide continuity across time. While this outcome is not always feasible for practical reasons, it should be maintained as an objective and given a significant priority in the management of policy and tax design.

2.2. International Taxation Arrangements

Significantly greater integration of national economies through the strong growth in foreign trade and investment in recent decades presents a more complex and challenging world for tax authorities. Governments have sensibly responded to this through a range of measures on both a bilateral and multilateral basis.

The OECD has continued to develop the international tax convention that underpins most international tax treaties and has coordinated measures to secure exchange of information agreements with jurisdictions regarded as tax havens. AFMA has on a number of occasions made submissions to OECD tax policy working groups. The ATO has a significant international profile and is an active participant in the work of the OECD. We think this participation should continue in order to ensure that Australia's interests are protected when international tax policy matters are being discussed.

The Australian government has modernised our international tax agreements, most notably in recent years with the US and the UK. The bilateral tax treaty process is transparent and open to scrutiny through the Parliamentary process, amongst other things. AFMA has found government consultation on the tax treaty process helpful as a mechanism to identify issues relevant to industry that might improve the operations of the treaties. We would encourage the government to maintain open lines of communication with industry on these matters to the greatest extent possible.

ATO is a foundation member of the Joint International Tax Shelter Information Centre (JITSIC), which was established in 2004 together with the tax administrations of Canada, the UK and the US.⁴ JITSIC supplements the ongoing work of the tax authorities in identifying and curbing tax avoidance and shelters and those who promote them and invest in them. It is a rational response to the challenge of administering an increasingly complex tax system based in an international economy. ATO has commented on the effectiveness of JITSIC but there is limited public information available about ATO's approach to the conduct of its affairs through JITSIC.

Given the growing importance of international cooperation in tax and regulation, there should be a clearly articulated set of policy principles that underpin ATO's role in, the governance of, and the operational workings of cooperative initiatives like JITSIC. It would assist Australian taxpayers to understand the role and priorities of such cooperative arrangements if there were greater transparency around their activities, their relevance to particular taxpayers and the protocols under which they operate (eg such as controls on information sharing between agencies). Greater transparency would support a broader understanding of JITSIC and promote industry engagement in its processes, which might assist the tax administrations to better design and target strategies to achieve the stated objectives and deliver the most effective use of public resources. The benefit from this more open approach would be more significant as the profile of JITSIC increases over time.

3. Concluding Comments

We hope the above comments and suggestions are useful to the Review and we would welcome further consultation on these matters. Please contact David Lynch, Head of Policy

⁴ Japan has since joined JITSIC, China is an observer and South Korea has been offered observer status.

and Markets, at dlynch@afma.com.au or (02) 9776 7991 if we can be of any further assistance to the review.

Yours sincerely

A handwritten signature in black ink that reads "Duncan Fairweather". The signature is written in a cursive, slightly slanted style.

Duncan Fairweather
Executive Director