AFMA

17 October 2008

AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

Australia's Future Tax System

The Australian Financial Markets Association (AFMA) welcomes the opportunity to submit comments on the Government's review of Australia's Future Tax System (the Review). 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, state government treasury corporations, fund managers, traders and other specialised markets and industry service providers.

The Review provides a good opportunity to reconsider the balance of taxes on the returns from work, investment and savings, and consumption. The banking and finance sector interacts with the tax system through a myriad of channels; as a significant contributor to tax revenue through company taxation, a large employer of the Australian workforce and, therefore, facilitator in the tax and transfer system and as the provider of financial products and services that are subject to various tax rules.

In our view, tax rules and policies should strive for simplicity and certainty. Tax neutrality across markets and products is the ideal outcome, and tax considerations should not inform or influence investment decisions. In addition, financial markets are global, so the balance of taxes on companies and investments should also be considered with reference to Australia's global competitiveness.

Within the context of these high level principles, we outline in the attachment some specific areas we believe the Panel should consider in its review of the tax and transfer system. We hope these comments are useful to the Panel, and would welcome further consultation on these matters. Please do not hesitate to contact David Lynch, Head of Policy & Markets, at dlynch@afma.com.au or (02) 9776 7991 should we be of further assistance.

Yours sincerely

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1. TAX RATES AND RULES

1.1 The General Level of Taxation

Corporate Tax Rate

The Review should consider the feasibility of a lower corporate tax rate to improve Australia's competitiveness. Corporate tax rates in Australia are significantly higher than key competitors in the region and higher than the OECD average, evidenced by a report that ranks Australia 122 out of 178 with regards to the tax burden on business[1]. The same report also ranked Australia 41 in relation to the ease of paying tax, a function of the number of taxes, the time taken to comply and the total tax rate.

Australia places an exceptionally high reliance on corporate tax revenue as a percentage of total tax revenue[2]. For industries, such as banking and finance, which operate in a globally competitive environment, a relatively high tax burden presents a competitive disadvantage for the domestic industry. A reconsideration of the balance of taxes as they affect businesses would also increase Australia's attractiveness to foreign investment, which is a naturally important source of capital to business in Australia as a capital importing country. It would also complement the Government's policy objective of promoting Australia as a regional financial services centre.

Personal Tax Rate

The finance sector competes globally for talent, with a high volume of movement of senior banking executives, managers, traders and other specialists into and out of Australia. This is a good thing in terms of the opportunities afforded to Australians to advance their careers and to facilitate the transfer of skills into Australia. Australian finance professionals are keenly sought overseas and many take that opportunity to develop their careers and accumulate wealth in more favourable tax regimes. Australia's high personal tax rates, as well as presenting a disincentive to the ordinary Australian, creates a disadvantage for Australia in the global competition for talent. Part of the tax reform process should be to consider how best to improve the incentive structure and competitiveness of the tax system, whilst ensuring that social infrastructure (which is also an integral part of Australia's competitive advantage) is not diminished.

1.2 Interest Withholding Tax on Banks and Financial Institutions

Taxation reform should remove interest withholding tax (IWT) imposed on non-resident funding by financial intermediaries, including related party funding. Australia relies on foreign capital inflows to fund the balance of payments current account deficit and taxation should avoid impeding this process to the greatest extent possible. Business benefits of eliminating non-resident withholding tax for financial intermediaries include:

- Cheaper overseas debt funding for Australian businesses, more innovative funding arrangements, lower tax compliance costs and less

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[1] The PricewaterhouseCoopers "Paying Taxes 2008" Report, total tax rate ranking.
[2] In the OECD "Tax Policy Studies 16: Fundamental Reform of Corporate Income Tax" (2007) Report, Australia has the second highest reliance on corporate tax as a percentage of total tax revenue.

tax uncertainty; all important given the significance of overseas funding to the Australian financial system;

- Enhanced competition as both bank and non-bank financial intermediaries can fund more efficiently from their parents; particularly in the current credit climate where local funding is more restricted on a term basis. This increases reliance on parent funding to maintain their Australian business presence at the desired level; and
- Increasing the global competitiveness of Australia's financial sector; such as greater regional liquidity management opportunities, as withholding tax on flows into Australia is a barrier to this activity at present.

Tax revenue implications are manageable because:

- The extension of tax relief through the double tax agreement renegotiation process (notably with the UK and USA) has significantly contracted the IWT base;
- Domestic tax law changes over the years have expanded the exemption from IWT (under s.128F) and narrowed the withholding tax base;
- Tax revenue leakage in respect of the remainder of the IWT base would be unchanged, so the remaining tax base would be at no greater risk than at present.

The IWT exemption for financial intermediaries should include an exemption for intra-bank funding of foreign bank branches in Australia. In the absence of a full exemption for financial intermediaries, the Government should independently address the intra-bank and intra-group funding issue without delay. The effect of the current 5% IWT on intra-bank funding is to force foreign bank branches to fund through less efficient sources (free of withholding tax) and limit opportunities for international business.

The ongoing credit crisis has emphasised need for immediate reform in this area because parent funding has become more important for some foreign financial institutions (both branches and subsidiaries) in the face of tightening credit conditions. For instance, it has been more difficult to obtain term funding (eg for 6 month to 1 year) from the market, so parent funding helps to support a prudent approach to liability management. However, the funding is more expensive than normal financing due the interest withholding impost (5% for foreign bank branches and 10% for subsidiaries). This ultimately reduces competition and potentially the amount of credit available in the wholesale banking and securities markets through these entities.

The withholding tax problem for foreign bank branches is exacerbated because the amount of associated interest expense that is deductible for tax purpose is capped at the LIBOR rate under Part IIIB of the Income Tax Assessment Act. Apart from generating unnecessary tax compliance costs for foreign bank branches, this further penalises them because banks of good credit standing cannot always fund at the LIBOR rate given the current credit stress in the market.

More generally, in the absence of an exemption, the bias will remain for a foreign bank to lend directly from overseas to an Australian company (free of withholding tax under a tax treaty) rather than use the Australian branch for this business. Moreover, Australia could not fully draw upon the potential benefit to banking competition in the domestic market (see Attachment 1 for more details).

1.3 Taxation of Financial Products

In a modern economy, a myriad of financial products are offered to investors to manage their wealth. A healthy economy is synonymous with the ability for investment and risk management decisions to be made without being hampered by an uncertain and complex tax system. Within this context, there must be clearer rules and guidelines that provide a more certain environment for the taxation of financial products. In our experience, the ad hoc manner in which tax policy and rules for financial products, particularly structured products, are developed have created unnecessary complexity for investors.

The taxation of capital protected borrowings is a prime example of this problem, which has been subject to numerous changes over the past decade because of the lack of a clear policy or rules to implement it (see Attachment 2). Consequent to a measure announced in the 2008 Budget, we now have a situation where the benchmark interest rate to determine the level of interest expense deductibility does not accord with the real cost of funding capital protected products in the market. This distorts the tax system and has discouraged investors from obtaining protection at a time of market volatility when it would have been of most benefit in terms of protecting their capital. Thus, the economic cost to investors of getting policy wrong in this area can be significant.

To maintain an innovative and competitive financial system, it is important to provide clear, stable and sensible tax policy principles that support an internally consistent set of rules for the taxation of financial products. This requires an appreciation of the lending and risk transfer function in the financial system and a capacity to assess these aspects from a tax policy and administration perspective, amongst other things. This is an area where the Review’s work might contribute to a more efficient tax system.

1.4 Australia as an International Financial Centre

AFMA believes that, under the right conditions, there is a real opportunity to increase our share of international financial services business. For example, we have a strong capability in funds management and we have the potential to capture a significant share of the market for emissions trading services in the region. Australia faces stiff competition for this business from other centres in the region, notably Singapore and Hong Kong.

Taxation is a significant consideration in determining the location for business. The issues outlined in this submission are relevant to our success in this area; including the general level of taxation, IWT reform, efficient tax administration as well as the Taxation of Financial Arrangements (TOFA) reform that is under way.

In addition, going forward it will be necessary to maintain a willingness to address tax issues that impact our international competitiveness in a timely and pragmatic manner. For instance, foreign investment funds (including their associates) that invest foreign-owned funds but which use Australian-based investment advisors in the course of their investment are concerned that they would become subject to tax in Australia. This concern arises by reason of the physical presence of those investment advisors in Australia technically giving rise to Australian source income. AFMA has recommended to the Government that Australia should introduce an exemption for offshore funds similar to that offered in competing jurisdictions. Issues of this type should be dealt with in an expedient manner that is to the greatest extent possible consistent with the Government's financial centre policy objective.

2. TAX POLICY DESIGN AND IMPLEMENTATION

Tax policy design and implementation in Australia must be improved if we are to maximise the efficiency of the tax system and Australia's global competitiveness. In particular, the Government needs to allocate greater technical resources to the care and maintenance of the corporate tax system. Corporate tax revenue in total has grown rapidly in recent years to almost $70 billion in 2007; yet the technical policy and drafting resources allocated to managing the law in this area does not seem to have changed materially.

Example – TOFA

15 years into the taxation of financial arrangements (TOFA) project, we still do not have a set of rules in legislation to modernise Australia's rules. This initiative is especially important to banks who account for a significant portion of corporate tax.

This long overdue modernisation of the tax system would enhance its efficiency and effectiveness, produce compliance cost savings for taxpayers, and provide a more meaningful revenue integrity check for the Australian Tax Office. The current divergence between financial institutions' financial accounts and tax records imposes a high cost and greater operational risk for banks and securities companies, as well as complicating the administration of the tax system.

In addition, Australia's current method for taxing financial arrangements is out of step with international practice. This creates tax compliance problems for the conduct of international business in Australia, as the information outputs of global reporting systems do not align with the Australian tax requirements. Hence, the introduction of modern tax arrangements would improve our competitiveness as an international financial centre.

There are a myriad of minor tax issues that seemingly will never see the light of day in terms of legislation to correct them. These are generally issues that are relevant to only a small part of the economy (eg foreign bank branches) or involve technical fixes that do not have significant revenue implications. However, they do impact on businesses affected and are a drag on the competitiveness of doing business here. Examples include the lack of clarity about the treatment of intra-bank equity derivative transactions and deficient expense allocation rules for offshore banking units (OBUs).

Left unattended for many years, these issues can eventually manifest themselves in a very harmful manner. For example, the amount of interest expense on intra-bank (ie foreign parent to Australian branch) funding that is deductible for tax purposes is capped at the LIBOR interest rate. This generates unnecessary tax compliance costs for foreign bank branches and some inequity, which could simply be resolved by applying normal transfer pricing principles to these transactions. While this has been a relatively minor issue in the past, the impact of the credit crisis has recently brought the issue to the fore (as outlined above). The impact of the cap is to penalise banks that cannot fund at the LIBOR rate because of their current standing in the market, or because the actual market rate at the time a deal is done is higher than that established during the LIBOR rate setting period. This outcome cannot be justified by tax policy and is inconsistent with more general banking and competition policy.

Too often when industry raises an issue, the Government response is that there are no drafting resources available, Treasury does not have the resources to deal with an issue or there is no availability in the Parliamentary timetable. If the corporate tax system is a social asset, in terms of its role in funding government services to the public, then sufficient resources in terms of quality and quantity to maintain the asset (the tax system) at its most efficient level must be met.

Example – Capital Protected Products

Even measures that have been subject to a Government announcement and are effective from date of announcement can be left to drift for extended periods. A notable example in this regard is the change to the taxation of financial products announced in April 2003, the rules for which took four years to be put into legislation. The delay highlights several deficiencies in the tax policy process including inadequate policy analysis before the measure was announced and insufficient resources to finalise the policy and develop the associated tax rules for legislation (including drafting resources). Moreover, less than a year after the new rules took effect, the law was again changed from date of announcement in May 2008 and the whole process of investigating the appropriate policy and rules began again. Meanwhile, there is understandable frustration amongst issuers, advisers and investors about the frequency of changes to the tax rules.

There is clearly something amiss in the tax policy development and implementation process for a situation outlined in the above example to have occurred. This is a relevant subject for the Review. The Tax Design Review Panel has made observations and recommendations in this area,[3] which provide a solid basis for improvement. However, there is a significant practical challenge in moving from the making of a recommendation to its comprehensive implementation, especially when competing objectives emerge. The Review should emphasise the importance of an effective tax policy development and implementation process to a tax system that serves the community's interests in a systematic and complete manner.

3. TAX ADMINISTRATION

3.1 Administration Process

Good tax administration reduces compliance costs, disputes and tax uncertainty for business. AFMA has supported previous ATO measures to improve tax administration and continues to press for improvements.

The ATO has undertaken significant initiatives in recent years to improve the tax administration process for taxpayers – in effect, bringing it closer to a real time process. For example, the priority tax ruling procedure has provided quicker tax guidance for key corporate activities.

[3] Tax Design Review Panel — *Better Tax Design and Implementation,* April 2008.

ATO still needs to improve aspects of its performance, especially in terms of its understanding of business and financial markets and building greater mutual trust with industry.

3.2 Technical Guidance

There are important areas of the ATO's provision of technical guidance where improvement is required. In particular, ATO's technical views should attach a higher weight to the reality of the market, and how ordinary business transactions are done and should be facilitated under the law. Within this context, the industry has in the past had difficulty reconciling the reality of the market with ATO's view on aspects of the OBU regime and the application of the debt/equity rules.

Moreover, there is clearly something amiss with the tax system (that is policy, legislation and administration) when there are significant areas of disagreement between ATO and industry on the meaning of law that has not long been passed by Parliament (eg the debt/equity rules). This situation arises even after extensive consultation processes have been undertaken at the legislation development stage. This is not a good sign for the health of the tax reform process more generally and, in some instances at least, would appear to reflect the need for a more pragmatic, market based view by the Tax Office.

4. GST REFORM

Whilst the principle design of the goods and services tax (GST) is to tax private consumption, the current input taxation of financial supplies distorts this principle. Input taxation creates a cascading of tax as embedded GST costs passed on by financial supply providers cannot be recovered by business acquirers. The embedded GST then forms part of the cost base of businesses upon which GST is later applied. Ultimately consumers bear the cost of this double taxation - the embedded GST and the GST applied by businesses.

This design flaw is not unique to our GST regime. Australia has attempted to alleviate this cascading of tax by limiting input taxation to a narrower range of supplies and widening the scope for GST credit entitlement compared to other jurisdictions. However if Australia were to adopt the New Zealand approach and treat business-to-business (B2B) financial supplies as GST free, the cascading of tax could effectively be eliminated.

There have been moves in other European and Asian jurisdictions to examine similar proposals in the context of B2B transactions. In this regard, we strongly recommend the Review to consider GST free treatment of B2B financial services.

Attachment 1 – Foreign Branch Bank Intra-bank Funding & IWT

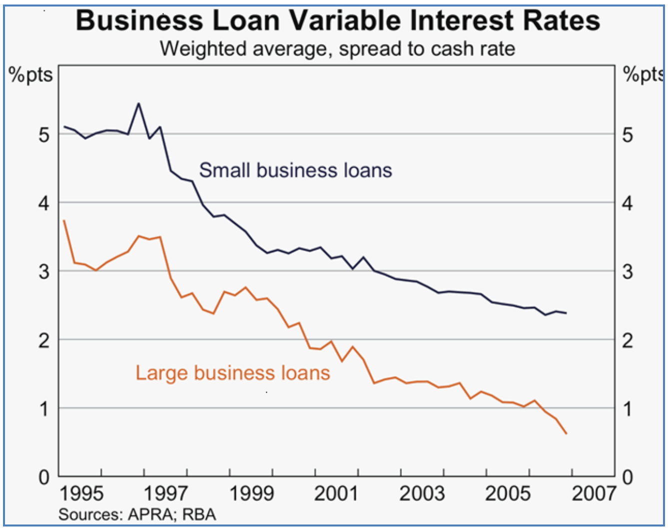
Foreign bank branches pay a 5% IWT on interest paid on funds received from their parent. This is a cost impediment to the efficient funding and liquidity management of foreign branch banks in terms of tax payable and administrative cost to recover tax credits where they are available. While foreign banks may avail of the s.128F withholding tax exemption for borrowing from third party non-residents, this relief is not available for funding through their parent entity.

The withholding tax effectively curtails the ability of foreign branch banks to fund from their parent and, thus, has a negative impact on competition in the domestic banking market to this extent. Parent entity funding can be advantageous for a variety of reasons such as quick access to funds or better liquidity, efficient capital management and minimising client limit constraints. Moreover, because active regional liquidity management through a branch in Australia requires the regular movement of funds into and out of Australia, the associated withholding tax cost effectively precludes this form of business from being done in Australia.

Banking Competition Issues

Foreign banks have contributed significantly to competition in the domestic banking market since the foreign bank branch regime was introduced in 1993. This has contributed significantly to the lower cost of loan finance to business, as outlined in Chart 1.

Chart 1



Source: RBA

This is also reflected in the market more recently, as the Reserve Bank of Australia has observed in the March 2007 Financial Stability Review:

> *"Much of the pick-up in foreign-owned banks' business lending growth has been in 'large' loans (defined as loans over $2 million), with these banks accounting for around one quarter of outstanding bank loans of this size. The activity of foreign-owned banks appears to have been one of the catalysts for stronger competition in this market, which in turn has been associated with a contraction in lending margins."*

The intra-bank interest withholding tax also makes it less attractive to do certain other business from Australia; for instance, an Australian company could borrow from a parent bank free of withholding tax under an international tax treaty but there would be an indirect withholding tax impost when those funds are provided to the client through the branch in Australia. The withholding tax also leaves banks under international tax agreements, like the US and UK agreements, in a position where they can borrow funds from other banks in their parent's jurisdiction free of withholding tax but must pay withholding tax on funding from their own parent.

In this context, it is relevant to note that the Reserve Bank in the March 2007 Review also commented that:

> *"Domestic banks face competition from banks located overseas, with the value of cross-border loans outstanding to Australian businesses increasing strongly in the past two years, to stand at around $45 billion at end 2006, compared to an average of around $20 billion over the preceding decade"*

IWT was imposed on intra-bank funding in 1993 to contain the risk of tax revenue loss and the Government's budgetary constraints. These reasons are no longer valid given the marked improvement in the Government's budgetary position and, more importantly, the expansion of IWT relief in the last decade through double taxation agreements and changes to domestic law that substantially eliminate the tax cost to change.

The effect of the current regime is to force banks and financial entity branches to fund through less efficient sources (rather than necessarily pay withholding tax) and limit opportunities for international business. Therefore, AFMA requests the elimination of interest withholding tax on funding by foreign banks and financial entity branches from the overseas parent. Removal of this barrier would improve the ability of foreign banks to conduct international business from Australia, as well as expanding funding opportunities and improving the efficiency of the tax regime for their domestic operations here.

Attachment 2

Assume 10-yr self-funded instalment warrant

Assume 1 warrant purchased each year at March

		Applicable tax rules to each year's instalment warrant issue										
	Year warrant purchased:	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
1	Full deduction (Pre-Firth case)	✓										
2	Part IVA	✓										
3	Limited deductibility 1 (Avg of unsecured loan and credit card rates)	✓	✓									
4	Limited deductibility 2 (lwr of unsecured loan rate or 80/85% of interest)			✓	✓							
5	CGT Black hole	✓	✓	✓								
6	Full deduction (Post-Firth case)	✓	✓	✓	✓	✓						
7	Transition rule (03-07) - matrix 85% deductible						✓	✓	✓	✓		
8	Unsecured personal loan rate										✓	
9	Standard variable home loan rate											✓
	Number of different benchmark rates the investor must calculate in making a tax return in 2009	4										