Australian Government

The Treasury

COSTING MINUTE

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To: **Neena Pai, Australia's Future Tax System**

Cc: **James Kelly, Australia's Future Tax System**

TITLE AFTS proposal - to better target interest withholding tax to remove distortions created by existing arrangements.

SUMMARY OF PROPOSAL

Intent of the proposal

AFTS proposal will remove some of the distortions that currently arise from the inconsistent application of interest withholding tax (IWT).

For example, although IWT is notionally imposed at a rate of 10% on all interest paid by an Australian borrower to a non-resident lender, the numerous IWT exemptions (detailed below) mean that current arrangements distort how debt is accessed and intermediated in Australia. For example, the IWT exemptions favour wholesale debt over retail debt.

Current taxation treatment/problem

Payments of interest made by Australian borrowers to non-resident lenders are liable to interest withholding tax at a rate of 10%.

However, there are a range of exemptions from IWT in the domestic law and in tax treaties. IWT does not apply to:

- 'publicly offered' debentures and certain debt interests (such as syndicated loans) [section 128F of the Income Tax Assessment Act 1936]

- offshore banking units [section 128AE of the ITAA 1936]

- all state government bonds [section 128F of the ITAA 1936]

- sovereign wealth funds (this is not condified in statute)

- tax-exempt foreign superannuation funds (paragraph 128B(3)(jb) of the ITAA 1936)

Interest paid by the Australian branch of a foreign bank to its foreign parent is subject to IWT at the rate of 5% (section 160ZZZJ of the ITAA 1936)

The US, UK, Japanese treaties provide IWT exemptions for interest payments made by Australian borrowers to financial institutions located in the US, UK and Japan. This exemption is likely to be negotiated in all future tax treaties (or protocols to tax treaties).

Currently, IWT applies to Commonwealth government bonds, however, there is a bill currently before Parliament to make interest paid on Commonwealth government bonds exempt.

IWT therefore applies primarily to: related party debt; debt from a financial institution where a treaty exemption does not apply; and non-resident retail deposits in Australia.

Proposed taxation treatment

The proposal will remove IWT from all interest paid by or to a "financial institution" operating in Australia, including where the debt on which interest is borrowed from a related party. Operating in Australia refers to a financial institution that is resident in Australia or is an Australian branch (permanent establishment) of a non-resident entity.

Financial institutions will include: Authorised Deposit-taking Institutions (banks, building societies and credit unions); non-ADIs (merchant banks, finance companies and securitisers) . That is, institutions that engage in financial intermediation.

One exception to the above rule is in relation to non-resident retail deposits held in Australia. These deposits will continue to attract the 10% IWT.

The IWT exemption will not extend to interest paid by that part of a company that performs internal treasury functions.

The IWT exemption will not extend to interest paid by insurers or managed funds because these entities do not primarily engage in financial intermediation, rather, they trade in financial instruments (and manage collective investments).

ELEMENTS AND OPTIONS

Elements

Element ID	Description
A	Better target IWT to remove distortions created by existing arrangements

Options examined

Option ID	Option	Assumed start date	Was a Departmental Impact Assessment sought?	Was a Tax Regulation Impact (preliminary assessment) sought?
1	A	01/07/2010	No	No

FINANCIAL IMPLICATIONS

IMPACT ON FISCAL BALANCE - ACCRUAL-BUDGET ($m)

Option ID	Year of Maturity	2008-09	2009-10	2010-11	2011-12	2012-13
1	2013-14	-	-	-210	-200	-220
	Revenue	-	-	-210	-200	-220

- Nil

IMPACT ON UNDERLYING CASH BALANCE ($m)

Option ID	Year of Maturity	2008-09	2009-10	2010-11	2011-12	2012-13
1	2013-14	-	-	-210	-200	-220
	Revenue	-	-	-210	-200	-220

- Nil

The costing of each option has been undertaken independently from those of other options, meaning that the costs are not necessarily additive.

RELIABILITY

The Tax Office believes that this proposal will have a significant impact on revenue. However, this impact could be much higher due to the behavioural impact of taxpayers changing their financial arrangements to take advantage of the exemption in the proposal. These behavioural impacts have not been included in the above estimate.

It is also thought that this proposal will have broader implications regarding Australias current double tax agreements and tax information exchange agreements, and any agreements to be established in the future.

Currently companies submit reports to the Tax Office containing details of payments relating to all withholding taxes (interest, dividend and royalties). This assists in identifying tax evasion and avoidance and is also used as a key bargaining tool for Australia when negotiating new treaty terms, particularly with taxation information exchange agreements.

If interest withholding tax is completely abolished for financial institutions then the data source used to populate the Tax Offices current outgoing exchange of information with other countries agreed to under existing taxation information exchange agreements will not be complete. This would impact on the Tax Offices ability to receive data from other countries, as the whole exchange program is voluntary and depends on reciprocity.

If interest withholding tax was reduced to a zero percent rate, then the current reporting regime could then be maintained with the current level of compliance costs maintained for those companies involved. As this reporting system has been in place for several years it is not thought that the compliance costs associated with the system are high.

Reliability of estimate

This estimate is based on current interest withholding collections data, which is informational and is reliant on taxpayers filling out the labels correctly. As these labels are not audited, the estimates are of low reliability.

COSTING DETAILS

Methodology

The interest withholding tax was grown to determine the amount collected from 1 July 2010. A clawback was calculated using only the NRIDRAR data, giving the following revenue impact:

Financial Year	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**
	$m	**$m**	**$m**	**$m**	**$m**
Revenue impact	-	-210	-235	-255	-280
Clawback	-	-	35	35	40
Total impact	**-**	**-210**	**-200**	**-220**	**-240**

-nil

Data

Data was extracted according to ANZSIC codes 62100, 62210, 62220, 62230, 62290 and 64110.

Income Year	2005-06	2006-07	2007-08
Estimated collections	**$m**	**$m**	**$m**
Interest withholding tax	90	100	165

Estimated collections are based on data from two sources:

The AIIR database (Annual Investment Income Report) which details transactions involving individuals and non-individuals who are investing in companies in Australia.

The NRIDRAR data base (Non-Resident Interest Dividend and Royalty Annual Report) which details more commercial based transactions.

Entities choose which report to submit depending on the type of transaction relating to the payment. To come up with estimates of historical collections, the data from the two sources are combined.

Assumptions

Rounding:

- All estimates and data are rounded to the nearest $5 million.

Growth rate:

- A growth rate of 8.8% was used in line with Tax Office generated parameters used for interest withholding tax forecasts.

Tax rate:

- A company tax rate of 25% has been used, in line with Treasury assumptions of the future company tax rate under the Australia Future Tax System review.

Clawback

- Clawback will only occur for the parts of interest withholding tax that will relate to loans obtained by Australian companies, as they currently bear the burden of interest withholding tax.

- For costing purposes it has been assumed that the interest withholding tax reported through NRIDRAR relates to loans obtained by Australian companies, so this portion would incur clawback through company collections. There would be no clawback occurring for interest withholding tax reported through AIIR, as this interest relates to foreign investors who bear the burden of the interest withholding tax.

Timing has been assumed to be as follows:

- 70% remitted by large payers, who pay all of their liabilities in the same year that they were incurred.
- 25% remitted by monthly payers, with 92% collected within the year, and one twelfth (8 %) is lagged to the next financial year.
- 5% remitted by quarterly payers, with 75% collected within the year, and 25% lagged to the next financial year.
- All clawback will occur on assessment, so this has been lagged one year.

ADDITIONAL INFORMATION

Departmental impacts

An assessment of the Departmental Impact has not been requested.

Tax Regulation Impact (preliminary assessment)

A preliminary assessment of the Tax Regulation Impact has not been requested.

All material provided in this minute must be cleared by the Tax Analysis Division incorporated into Executive Minutes, Cabinet Submissions, any other briefing material, or when used for external purposes.

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