INTERNATIONAL
BANKS AND SECURITIES
ASSOCIATION OF AUSTRALIA

7 August 2001

The Hon Peter Costello
Treasurer
Parliament House
Canberra
ACT 2600

Dear Treasurer

New Business Tax System (Debt and Equity) Bill 2001

IBSA supports the Government's intention in introducing the New Business Tax System (Debt and Equity) Bill 2001 to provide greater certainty and coherence in tax law. Our review of the Bill leads us to conclude that certain provisions in the Bill need to be modified, as we suggest below, to deliver this outcome.

Key problems that we have identified include:

- Far from reducing uncertainty, the Bill would actually increase it, by granting the Commissioner extensive discretionary power;
- Proposed limits on interest deductions (section 25-85) would create a new tax black hole for taxpayers.

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2. Limits on Interest Deductions – Section 25-85

Returns on some debt/equity hybrid instruments that satisfy the debt test may not be deductible under section 8-1 of the *Income Tax Assessment Act 1997* because they may be contingent on the economic performance of the issuing company, or may secure a permanent or enduring benefit for the company. If, but for this obstacle, a return on a debt interest would satisfy section 8-1 then the return should be deductible and the objective of section 25-85 is to ensure that this is the case. This objective is correct and welcome – in simple terms it means that if interest is paid on a debt interest then it should be deductible for tax purposes.

A problem arises because deductibility of affected interest payments is limited by reference to a benchmark rate plus a margin of 150 basis points. In essence, this is described as a mechanism to protect revenue by preventing equity dividends being paid through interest payments on hybrids. However, it appears logical that if returns were declared non-deductible because they were deemed to be equity returns, then they would be given the same treatment as actual equity returns. This does not appear to be the case, as returns that exceed the benchmark rate by more than 150 basis points would not be treated as dividends and, hence, would not be frankable.

This outcome is unfair for two reasons:

1. If the interest is placed on the debt side of the debt/equity divide in the new tax rules, then the returns in respect of it should be treated like debt – to do otherwise, as is proposed, suggests that there is a structural flaw in the debt equity rules that underpin the Bill;
2. If the revenue protection argument is still considered to have merit (which is arguable) and the returns are to be treated as returns to equity, then they should be frankable like other equity returns – the Bill does not provide for this.

Because it fails to apply a consistent approach to debt and equity returns, the proposed approach would introduce a new tax back hole for taxpayers and, thus, conflict directly with the thrust of tax reform. The Government should insist that this flaw is corrected, by requiring a consistent treatment of instruments as debt or equity under the new rules.

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4. Concluding Comments

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We have discussed another difficulty with the Bill in s.25-85 that needs to be addressed. We are still examining other technical aspects of the Bill and will raise any issues arising from this in the next week.

We believe that our proposals would enhance the effectiveness of the legislation in meeting the Government's stated objectives for it and recommend that they be adopted. We would be happy to discuss any issues arising from this submission.

Yours sincerely

Executive Director