23 October 2008

Review of Australia's Future Tax System
The Treasury
Langton Crescent
PARKES ACT 2600
Email: aftesubmissions@treasury.gov.au

Dear Review Panel

ING Bank (Australia) Limited ("ING Direct")
Submission on the Introduction of a Domestic Exemption from Interest Withholding Tax for Banks

ING Direct welcomes the opportunity to make a submission to the Review of Australia's Future Tax System.

I refer to the Australia's Future Tax System (AFTS) Discussion Paper by Treasury Secretary Dr. Ken Henry at Box 8.8 at page 269:

"*Optimal tax literature suggests that, in the absence of location-specific rents, a small open economy should not impose source-based capital taxes when capital is perfectly mobile between countries .... as capital has become more mobile, countries have begun to compete to attract more capital investment.*"

Consistent with the above, ING Direct submits that with the global mobility of capital, the imposition of interest withholding tax on borrowings from non-resident financial institutions is a key impediment to the growth of foreign banks in Australia. In particular,

1. Interest withholding tax is a real cost of funds as interest withholding tax is levied on gross interest whilst income tax is payable by the offshore lender on the interest margin.

2. Often, the interest withholding tax cost is borne by the lender through the interest "gross-up" clauses in the loan agreements. This increases the cost of capital and this cost may be passed on to the consumers.

3. Most retail banks are funded by retail deposits and wholesale funding. Foreign banks like ING Direct do not have access to retail deposits in their home country or other countries without an interest withholding tax cost. The interest withholding tax cost places foreign banks at a significant disadvantage as compared to the Australian banks.

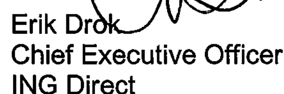
4. With the global credit crunch, there is limited access to wholesale funding. In addition, with the tightening of the global markets, all foreign banks' wholesale funding have been centralised at the parent level to manage efficient use of capital. The interest withholding tax cost is an impediment to foreign banks accessing available capital within the global group. This will restrict ING Directs' ability to grow its mortgage portfolio in Australia.

5. The interest withholding tax regime is uncompetitive when compared to the tax regimes in major financial services hubs such as UK, Ireland, US, Canada, Singapore and Hong Kong.

These are discussed further in the attached paper.

We would be pleased to meet with this Review Panel or Secretariat. If you would like to discuss this submission, please contact me on 9028 4465.

Yours sincerely,



Erik Drok
Chief Executive Officer
ING Direct

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Submission on the Introduction of a Domestic Exemption from Interest Withholding Tax for Banks

1. Introduction

ING Direct welcomes the Australian Government's interest in the financial services sector and the establishment of a dedicated team with oversight by the Government's Financial Sector Advisory Council to take charge of the financial services agenda. We support the Government's long-term reform strategy in building a future tax system that is internationally competitive. We also look forward to the outcomes of the Review of Australia's Future Tax System.

In light of the Australian Government's commitment to position Australia as a Financial Services Hub, ING Direct submits that to increase Australia's international competitiveness in the global markets, the Australian Government should introduce a domestic financial institution exemption from IWHT in respect of borrowings from non-resident financial institutions (irrespective of whether they are related or not).

As a minimum, we urge the Government to introduce a domestic exemption for bank-to-bank lending (irrespective of whether they are related or not) particularly in the light of the current Global Credit Crunch.

In addition, the introduction of a domestic financial institution exemption or bank-to-bank lending exemption should increase the level playing field for foreign banks like ING Direct in Australia, thereby, increasing competition in the Australian banking industry,

2. ING Direct – committed to Australia and Australia's 6th largest retail bank

By way of background, ING Direct is an Australian resident company which is an authorised deposit-taking institution licensed under the *Banking Act 1959*. ING Direct commenced operations in Australia in 1999 through the launch of on-line banking business in Australia. ING Direct is now Australia's 6th largest retail bank, with approximately $20 billion in deposits, $30 billion in loans and 1.25 million customers. The principal activity of the bank is the provision of banking and related services, through 3 operating divisions:

(i) Direct Business
(ii) Commercial Property Finance
(iii) Intermediary Mortgages

ING Direct:

- employs over 900 staff
- received the "Mortgage Choice Lender of the Year" award in 2008
- was named "Australia's Best Foreign Bank" in the Australian Banking and Finance Magazine Awards
- received Silver award for Best Term Deposit (Short Term and Long Term) in the Money Magazine "Best of the Best" 2008 Awards

ING Direct is ultimately owned by ING Groep NV in the Netherlands, a publicly listed company.

3. Interest Withholding Tax – a tax overlay with limited exemptions

Interest withholding tax ("IWHT") was introduced in 1967 as a means of collecting tax on Australian sourced interest income from non-residents. This tax effectively represents tax paid by the Australian borrower on behalf of the non-resident lender.

Broadly, IWHT applies to interest income that is paid by either a resident or non-resident borrower carrying on business in Australia to a non-resident lender (or even an Australian lender carrying on business outside Australia).

Since the introduction of IWHT in 1967, to date, there has been no change in the domestic IWHT rate of 10%. In setting the 10% rate, the Minister in his Second Reading Speech to the House of Representatives on the Income Tax (Non-Resident Dividends and Interest) Bill 1967 said:

"On the one hand, we are seeking to obtain a reasonable contribution to the Australian revenue out of interest payments flowing from Australia to foreign lenders. ***On the other hand, it is important that the rate of tax should not be so high that it could adversely affect our prospects of obtaining loan moneys from overseas, or result in interest charges being raised unduly against Australian borrowers***." (emphasis added)

Generally, the following IWHT exemptions are available:

(i) public debt offer provided that all the conditions in Section 128F Income Tax Assessment Act 1936 are satisfied (including no participation by ***associates*** in the offer); and

(ii) specific financial institutions exemption in respect of arm's length loans from ***unrelated parties*** in the recently renegotiated treaties (e.g. United Kingdom and United States of America).

The Commentary to the Interest Article in the OECD Model Convention on Income and Capital acknowledged that, unlike income tax which is levied on the interest margin earned by a lender, IWHT is levied on gross interest income resulting in IWHT being a real cost to the recipient especially where the recipient is a bank.

In the Explanatory Memorandum to the Protocol amending the Convention with the United States of America, the financial institutions exemption was introduced as the Government recognised that the "current 10% rate on gross interest can be excessive given their cost of funds." (paragraph 2.46). However, it is unclear why this exemption is only available on interest paid to unrelated parties.

Neither of the above exemptions is available to ING Direct where:

(i) an ING **related** entity participates in a public debt offer; or

(ii) the borrowing is from an ING **related** financial institution even thought the borrowing is on arm's length terms.

4. Why reform of the IWHT exemptions is needed

4.1 For Australia to be a Financial Services Hub its IWHT is at an uncompetitive setting

The Prime Minister, Kevin Rudd, in his address to the Financial Services Hub Summit in Sydney said that:

" the Government understands the importance of taxation for the international competitiveness of the financial services sector ..."

In the "Australia as a Financial Services Hub" Background Paper dated 31 July 2008, the Australian Government stated at page 1 that:

"A financial services hub is marked by a highly sophisticated, deep and liquid market with strong inward investment and strong activity in the export of services and skills."

Further, the Government at page 4 acknowledged that:

"An important issue for Australia is how to better position the financial services sector into the future. With a rapidly evolving global financial system and the continuing trend towards increased cross-border capital flows, it is important that Australia looks to harness opportunities."

The Government added at page 8:

"A competitive taxation system is important for attracting global capital, investment and the continued development of Australia as a financial services centre."

Australia's major competitor financial services hubs currently offer domestic IWHT exemptions for banks and the strong trend is for IWHT to be eliminated.

Examples of IWHT concessions for banks include the following:

Country	IWHT exemption
United Kingdom	IWHT exemption is available to payments of interest made by a bank in the ordinary course of its business. This covers borrowings from overseas **related** parties to the extent that the payment of interest is made by a bank in the ordinary course of its business.
Ireland	Similar to the United Kingdom, interest paid by or to a bank in the ordinary course of business is exempt from IWHT.
Switzerland	Interest payments from a Swiss bank to a bank outside Switzerland (whether **related** or otherwise) are exempt from IWHT.
Singapore	Interest payments from a bank in Singapore to a bank outside Singapore (whether **related** or otherwise) are exempt from Singapore IWHT. In addition, interest on deposits with approved banks are also exempt from IWHT.
United States	IWHT exemption for all interest paid with respect to deposits placed with persons carrying on a banking business so long as the interest is not effectively connected to a US trade or business of the recipient.

As well as the above IWHT exemptions limited to banks, there are general IWHT exemptions, applicable to all parties as follows:

- Hong Kong does not impose IWHT.
- From 1 January 2008, Canada eliminated IWHT on arm's length payments of interest to all non-resident investors (whether **related** or not).

In positioning Australia as a financial services hub, the Australian Government should look to incentives offered by other major financial services hubs to ensure that Australia remains competitive in the bid to attract more international capital. In this regard, the existing IWHT regime can be seen as a barrier to cross-border flows of capital.

More importantly for Australia, the above table shows that Australia's IWHT settings are not competitive with, not only other financial services hub countries, but the general trend to elimination of IWHT as illustrated in relation to Canada.

4.2 Global Credit Crunch: IWHT resulting in a higher cost of capital and reduced investment

The IWHT settings, while uncompetitive, might be mitigated by existing IWHT exemptions.

Unfortunately however, the global credit crunch which arose in 2007 has removed the mitigating effect of the existing IWHT exemptions.

The global credit crunch has resulted in significant dislocation in global funding markets, with financial institutions and corporations becoming more reluctant to lend giving rise to significant contraction in market liquidity. The tightening in funding has been particularly evident in cross border transactions.

Like all Financial Institutions ("FI"), the local entities of non-resident FIs have suffered from restricted access to local funding as a result of the credit crunch, particularly as the securitisation market has dried up. In many ways, however, they have suffered more than local entities as the local franchise is not as deep and local sources of funds have dried up. The result has been a greater reliance on offshore funding, particularly that which can be provided by their parent.

The only alternative for a non-resident FI is to issue paper in their own name (ie as the local arm of a global FI), which results in the institution having two faces to the market. In the current environment the additional complexity associated with two faces to the market is not desirable.

Typically the parents of local FIs are large global financial institutions with access to an extensive range and diversity of funding sources - that diversity being significantly greater than the major Australian FIs.

Having diversified funding sources is a key liquidity risk management tool for corporations, banks and countries like Australia. Diversification of funding sources provides great surety and price competitiveness, particularity in difficult times, such as the current credit crisis. Australia is very dependant on offshore funding. In order to ensure stability to the local finance industry it is important Australia has a wide spectrum of funding suppliers. The parent entities of major global FIs can provide an extensive and diversified source.

It is important for Australia that this large and diverse funding source be readily tapped. IWHT is an impediment to accessing this funding source.

Not only has the "credit crunch" reduced the supply of funds from "widely held" securities, forcing Australian banks to rely more heavily on loans provided by their offshore parents and affiliated banks, but the application of Australian interest withholding tax has also increased the cost of obtaining that inter-bank finance.

As outlined above, while Australian banks are not required to levy withholding tax on the interest they pay on "widely held" securities, they are required to levy 10% withholding tax on the interest they pay to their parent and affiliated banks offshore.

At first sight, this does not seem to be a problem, since it is the non-resident lender that is legally liable to pay the Australian IWHT on their interest income, not the Australian bank. However, whilst generally, the non-resident lender is entitled to claim a foreign tax credit in respect of the Australian IWHT, in most cases, the non-resident lender is only taxed in the foreign country on the interest margin and not the gross interest income. Accordingly, the excess foreign credit constitutes a real cost to the non-resident lender. In addition, there is generally, a time delay between the payment of the Australian IWHT and the realisation of the foreign tax credit in the hands of the non-resident. Therefore, we understand that although some non-resident lenders may, in principle, be eligible to claim credits for this Australian IWHT against their domestic tax liabilities, in practice, their willingness to do so is significantly reduced by the compliance costs and time delays associated with this process.

Consequently, in practice, the actual economic burden of this withholding tax is shifted back onto the Australian bank in the form of the higher interest rates.

This is because, in order to raise funds offshore, Australian banks have to be prepared to pay non-resident lenders **after-tax rates of return** on their investments that are at least as high as the rates of return that those lenders can earn on investments in other countries. This means that Australian banks have to pay higher rates of interest to non-resident lenders to offset any withholding tax that is imposed on the interest income of those non-resident lenders.

Indeed, many international loan contracts include a "gross up" clause where the borrower accepts liability for paying any taxes levied by the Australian government on the interest income of the non-resident lender.

By levying a 10% IWHT on the interest that Australian banks pay to their non-resident affiliated banks, the Australian Government is therefore increasing the interest rates that Australian banks must pay in order to raise that loan finance, thereby increasing the domestic cost of capital in Australia and the overall level of investment.

This is, of course, the reason why there has been an international trend towards reducing and eliminating taxes imposed on the interest income of non-resident investors. In view of the international mobility of capital, it is now well recognised that small capital importing nations such as Australia have to be prepared to pay non-resident investors the prevailing world rate of return if they want to attract investment.

This has also been recognised in the Australia's Future Tax System (AFTS) Discussion Paper by Treasury Secretary Dr. Ken Henry at Box 8.8 at page 269:

"Optimal tax literature suggests that, in the absence of location-specific rents, a small open economy should not impose source-based capital taxes when capital is perfectly mobile between countries .... as capital has become more mobile, countries have begun to compete to attract more capital investment."

4.3 IWHT decreases competition within the Australian banking market and impedes ING Direct's Australian residential mortgages growth plans

In general, Australian residential mortgages are funded from retail deposits and offshore borrowings (i.e. issue of commercial paper).

After the merger between St George and Westpac, ING Direct will be ranked 5th in the retail market measured by residential retail mortgages. To date, ING Direct's mortgage rates have been competitive in comparison to the Australian Banks.

Interest Rates as at 1 September 2008

Product	NAB	CBA	WBC	ANZ	SGB	INGD
Standard Variable Rate	9.61	9.58	9.61	9.62	9.67	[illegible]

The Big Four Australian Banks and St George have access to a large pool of domestic retail deposits. However, the IWHT cost is a barrier to foreign banks like ING Direct, tapping into its pool of retail deposits in its home country and any of the surplus pools of retail deposits (e.g. UK, USA and potentially Japan).

From an ING Group perspective, given the global credit crunch, there is an internal mandate to achieve a more efficient use of capital. With the material increase in the cost of external funds, ING Group has mandated that all new growth be funded by cash pools within the ING Direct worldwide group. In particular, ING Direct currently has surplus cash pools in different parts of the world. However, ING Group will not lend to Australia on the basis that the IWHT cost is too "expensive" from a group perspective. As a result, ING Direct will not be able to grow its residential mortgage business without access to cost efficient internal pools of funds within the ING Direct Group. This will place ING Direct at a significant disadvantage in comparison to the Australian banks.

5. Recommendation

In light of the Australian Government's commitment to position Australia as a Financial Services Hub, ING Direct submits that to increase Australia's international competitiveness in the global markets, the Australian Government should introduce an exemption from IWHT in respect of interest paid by financial institutions on borrowings from non-resident financial institutions (irrespective of whether they are related or not).

As a minimum, we urge the Government to introduce a domestic exemption for bank-to-bank lending (irrespective of whether they are related or not) particularly in the light of the current Global Credit Crunch.

As discussed above, similar IWHT exemptions are available to other major global financial services hubs in the United Kingdom, Ireland, Switzerland and Singapore.

This submission is less ambitious and less generous than the reform introduced in 2008 by Canada, a country broadly comparable with Australia, which now provides a unilateral exemption from IWHT on arm's length borrowings, whilst Hong Kong does not impose any IWHT.

The introduction of a domestic IWHT exemption for banks should result in a reduction in the cost of capital for banks, a better level playing field for foreign banks in Australia and a reduction in the cost of borrowing to Australian customers.

6. Revenue implications for the Australian government of this proposal should be minimal

We have set out below a table comparing the total IWHT revenue from all sources as compared to total tax revenue collected by the Australian Government from 2002 to 2007:

[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	2006-2007 [illegible]
Interest withholding tax	662	593	486	541	729	1,090
Total taxation revenue	177,838	194,827	209,560	229,131	245,223	261,988
IWHT / total taxation revenue	0.37%	0.30%	0.23%	0.24%	0.30%	0.42%

Source: Australian Bureau of Statistics: 2006-07 Taxation Revenue

It is clear from the above that the entire IWHT revenue constitutes less than 0.5% of the Australian Government's revenue. We do not have information about IWHT paid by banks.

The IWHT paid by banks is much smaller than the total IWHT shown above. From a banking perspective, the introduction of a IWHT exemption for banks should not result in a significant loss of revenue to the Australian Government. Prior to the Global Credit Crunch, most Australian retail banks (including ING Direct) were primarily funded by customer deposits and issues of commercial paper that are not subject to IWHT. Accordingly, until the recent Global Credit Crunch, the IWHT paid by Australia banks were negligible. As well, that IWHT would be further reduced on account of the IWHT concessions introduced into the US and UK double tax agreements.

We submit therefore that the revenue costs of this proposal would be minimal, in particular when compared with the potential which this recommendation provides for:

- Lower cost of funds for Australian consumers, including Australians financing their homes and
- The enhanced competitiveness for Australian banks.