

18 January 2016

Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
CANBERRA ACT 2600

By email: economics.reps@aph.gov.au

Dear Committee Secretary

Inquiry into tax deductibility

The Australian Bankers' Association (**ABA**) welcomes the opportunity to provide comments on the "Inquiry into tax deductibility".

With the active participation of its members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry. In particular the ABA supports the need for tax reform in order to ensure the Australian economy remains efficient and globally competitive.

Tax reform synchronisation

Given the Tax Green Paper process is currently in progress the ABA believes it is premature to review options aimed at wholly or partially denying tax deductions for financing costs. Debt funding is an integral and established component of a modern economy. The ABA considers that tax measures in respect of the use of debt funding should not be reviewed in isolation from other taxation design features and broader economic issues.

Importance of maintaining low cost capital

Australia has traditionally been a net importer of capital and this capital has been used to help fund the development of the Australian economy. Capital can take the form of equity or debt with the latter much easier to obtain. If the ability to claim deductions for debt funding is reduced, it would become more expensive on an after-tax basis, and the use of debt funding would likely fall. The capacity to replace debt with other forms of low cost funding is doubtful. Other sources, such as equity funding, would likely be as, if not more, expensive than debt. The potential consequences of falling levels of debt funding and/or its replacement with higher cost equity funding is that it could act as a brake on domestic investment and adversely affect economic growth.

Fundamentally, the importance of preserving low cost debt funding cannot be underestimated as it forms the basis upon which most consumers and businesses invest and grow. Debt funding can be raised and managed more efficiently than other forms of capital and these characteristics mean that it is regarded as an optimal option across all sectors of the economy.



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Global consistency

The generally accepted position amongst OECD countries is to allow interest deductibility for tax purposes. Most OECD countries also have inbuilt rules to ensure that interest deductions are not disproportionate to activity being undertaken.

In view of the above, any unilateral action by Australia to deny interest deductibility would lead to an inconsistency around the application of deductibility rules amongst OECD countries and growing uncertainty for Australian businesses. This is particularly relevant given the current focus being given to interest deductibility under the base erosion and profit shifting (BEPS) project (Action 4).

In our view, taking unilateral action to deny interest deductions would be contrary to global best practice and mean that Australia's tax policy direction would become isolated from that of most other countries.

Interest should be viewed and treated as a cost of running a business

As is the case with other expenses, interest paid on borrowings represents expenditure incurred in deriving income. As a general principle, the tax system should seek to tax the net income of businesses. This means that although the composition of costs incurred in arriving at net income may differ, the tax outcome will be the same in circumstances where the same level of net income is derived. Interest should be viewed and treated as a cost of deriving income in the same way as other expenses.

Limiting interest deductibility poses broad risks, including to Australia's financial sector

As noted above, Australia's reliance on capital means that unilateral action by Australia to deny interest deductibility would raise a number of significant risks.

Tax deductibility of debt is a major factor in investment and business decisions. The removal of deductibility would likely mean a significant shift to the existing balance of investment financing of projects across the economy. The impacts and consequences of altering that balance would need extensive consideration, particularly if changes were broad-based.

The raising of debt or restructuring of existing debt would likely shift away from Australia and into jurisdictions that allow deductibility for interest. The competitiveness of Australian banks would be adversely affected as the after tax cost of financing would be more expensive than that of global banking competitors. Measures that weaken the banking sector adversely affect its ability to support Australian consumers and businesses.

Previous reviews conducted by Government have consistently acknowledged the risks of increasing the cost of debt through limiting deductibility and the importance of preserving existing settings.

Preserving interest deductibility for banks should be regarded as a significant issue given the banking sector remains the primary source of financial intermediation for all sectors of the Australian economy. Therefore, the policy position for interest deductibility relating to financial intermediaries such as banks, lessors etc. needs to be considered separately to that of other companies/industries.

Other observations

- The existing thin capitalisation restrictions already limit the deductibility of company interest expenses.
- If changes are made to reduce the ability of a company to claim tax deductions for debt funding, there is a real risk that the logical commercial response would be to alter the business structure to that of a trust or partnership. As noted above, achieving horizontal equity between different types of investor is a key consideration.



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Interest deductibility and the personal tax system

Notwithstanding the above comments the following observations are relevant in the context of the personal tax system:

- Should individuals be denied (or restricted) deductions for financing costs associated with non-business income [“investment income”] a logical consequence would be that such activities would be shifted into different structures such as a trust or company. Hence it is not appropriate to consider individuals in isolation. Ideally a tax system will have horizontal equity between different types of taxpayer.
- Financing costs should be deductible except where they are incurred for private or domestic purposes. This restriction is principally relevant for individuals and already acts to significantly reduce tax deductibility.

Conclusion

Overall, the ABA believes that any review of the interest deductibility rules should only take place within the context of a broader review of the tax system and must ensure that Australia’s tax policy settings are not incompatible with globally accepted approaches. The ABA would also highlight that the financial intermediation role played by the banking sector is a specific consideration that must be taken into account in the context of any reviews of interest deductibility.

I trust these comments are helpful to your inquiry.

Yours sincerely

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