Chapter 15

Taxation issues and related matters

15.1 There were a number of issues raised during the inquiry relating to current taxation arrangements that restrict competition in the banking industry and possible changes to taxation arrangements that could promote greater competition. These include interest withholding tax, tax concessions on interest from household saving, GST input taxing, franking credits, debt write-offs, the Libor cap, Retirement Savings Accounts, First Home Saver Accounts and proposals to increase taxes on banking.

Interest withholding tax

15.2 Interest withholding tax (IWT) is levied on interest paid to a non-resident lender.

15.3 ING Bank regard IWT as one of the four key barriers to competition.[1] It is of relevance to foreign bank subsidiaries (but not branches). Its abolition was recommended by the Henry Tax Review and the Johnson report.[2]

15.4 The Government announced changes to IWT in the 2010-11 Budget:

- The tax on borrowings by local financial intermediaries from their overseas parents will drop, from 10 per cent to 7.5 percent from 1 July 2013 and to 5 per cent from 1 July 2014;
- The tax on borrowings by any Australian branch of a foreign bank from its overseas head office will drop from 5 per cent to 2.5 per cent from 1 July 2013 and then be abolished from 1 July 2014; and
- The tax applying to any financial institution that borrows from offshore retail deposits which they on-lend in Australia will be cut from 10 per cent to 7.5 per cent from 1 July 2013 and then to 5 per cent from 1 July 2014.[3]

15.5 Treasury explained the justification:

> The benefits of the phase down are that it will: help support banking competition; reduce the extent to which financial institutions make funding

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1 Mr Don Koch, Chief Executive Officer, ING Direct, *Proof Committee Hansard*, 14 December 2010, p 135.

2 The 2009 *Report on Australia's Future Tax System* and the Australian Financial Centre Forum’s 2010 report *Australia as a financial services centre: Building on our strengths.*

3 The Hon. Wayne Swan MP, 'Phasing down interest withholding tax on financial institutions to support banking competition', *Media release*, 11 May 2011.

choices based on tax rather than commercial considerations; and further develop Australia as a regional financial centre.[4]

15.6 ING Bank believe IWT should be cut further:

In Australia, we have nearly twice as much in loans as we do in savings. That is pretty consistent for the Australian industry…Elsewhere there is typically an excess of savings over loans. Most European countries and the North American countries have an excess of savings over loans. What we as a group would like to be able to do is take some of that excess and bring it to Australia and put it into Australian mortgages, because across the world Australian mortgages are now recognised as a very attractive investment…For our whole group, that makes a lot of sense because we are not going out to the markets and borrowing money to fund mortgages; we are taking it from related companies. It makes a lot of sense for the bank here in Australia and it means that, in the end, we will fund more Australian mortgages. What stops us from doing that is interest withholding tax.[5]

15.7 The Australian Bankers' Association claim that:

…these reforms [abolishing IWT] would promote more efficient capital flows, cheaper cost of funds, greater diversification of funding sources for Australia's banks (not just Australian major banks, but potentially Australian regional banks) and provide potential benefits for bank liquidity and lower interest rates for Australian borrowers…. It should be noted that the Government will broadly recoup lost IWT revenue from increased company tax earnings. The ABA notes that this reform provides opportunities for banks to diversify their funding sources, contribute to more efficient global capital flows and promote Australia as a financial services centre, especially in the Asian region.[6]

15.8 Asked about the cost involved, Treasury replied:

If IWT for financial institutions were to be removed with effect from 1 July 2011 (apart from IWT on non-resident retail deposits), it would result in an additional cost to revenue in the order of $750 million over the forward estimates.[7]

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4 Treasury, *Responses to questions on notice, no 14*, 4 February 2011, p 2.

5 Mr Mark Mullington, Chief Financial Officer, ING Direct, *Committee Hansard*, 14 December 2010, p 138. See also their *Submission 35*, pp 3-4. Similar views are put by Citi, *Submission 116*, p 2; Chamber of Commerce and Industry Quuensland, *Submission 43*, p 19; Dr Bob Such MP, *Submission 6*, p 2; and Australian Chamber of Commerce and Industry, *Submission 37*, pp 22-23. The tax was also noted as a barrier to competition by Professor Kevin Davis, *Committee Hansard*, 25 January 2011, p 63.

6 Australian Bankers' Association, *Submission 76*, p 54.

7 Department of the Treasury, *Responses to questions on notice, no 14*, 4 February 2011, p 2.

Committee comment

15.9 The Committee agrees with Treasury's argument for reducing IWT. The same reasoning, however, argues that rather than just phasing it down, it would be better to abolish it immediately. Treasury's estimates of the first round cost overstate the ultimate cost as the reform generates increased trading and employment in the finance sector and these costs should be outweighed by the benefits to other sectors from greater competition and narrower interest margins.

Recommendation 34

15.10 The Committee recommends that interest withholding tax be abolished as budgetary circumstances permit to increase the ability of foreign banks to compete in the Australian market.

Tax concessions on deposit interest income

15.11 The Henry Review found that real returns on ADI deposit accounts were subject to high rates of marginal tax:

> Interest has the least favourable tax treatment. The entire return, including inflationary gains, is included annually in taxable income, generating an effective marginal tax rate on the real return greater than the statutory marginal personal tax rate.[8]

15.12 The Government announced in the 2010-11 Budget a 50 per cent tax discount on up to $1,000 of interest earned by individuals, to commence on 1 July 2011. The measure was later delayed to July 2012 and the cap lowered to $500 for the first year.

15.13 The banks do not regard this as going far enough:

> While this reform will address some of the tax anomalies between interest bearing investments and other investments or asset classes (including shares, managed investments, property), it has been proposed in a manner that only applies in a limited way. In the absence of further reform, this is unlikely to provide tax incentives adequate enough to significantly influence consumers' savings and investment decisions, and therefore is unlikely to substantially shift the pool of domestic savings towards interest bearing deposits.[9]
>
> …there are also some other opportunities to support competition through taxation reform to increase or eliminate the cap on concessional taxation

8 *Report on Australia's Future Tax System,* Part One, December 2009, pp 32-33.

9 Australian Bankers' Association, *Submission 76,* p 53.

> treatment for bank deposits—where, currently, above the cap, depositors pay tax on the inflation component of their return…[10]

15.14 Taking an illustrative interest rate of 5 per cent, a depositor would need a deposit of $20,000 to gain the full benefit from the concession. Only about a tenth of household deposits are held in amounts of over $20,000.[11]

15.15 The banks called for the concession to be brought forward and/or the cap lifted:

> …by accelerating the introduction of the tax discount and removing the proposed $20,000 threshold for individuals to receive a 50% tax discount, this reform would address the imbalances within the current tax arrangements for deposits and provide an incentive for individuals to increase their savings using deposit accounts.[12]

> …we recommend that the Government reconsider its decision to delay the implementation of this tax concession on savings.[13]

Committee view

15.16 The Committee notes with approval that households have been saving more in recent years. This prudence should be encouraged. As well as giving households healthier balance sheets, encouraging savings in bank deposits would provide a more stable source of funds for banks and reduce their reliance on foreign borrowings.

15.17 The Committee notes the Henry Review's conclusions about the high marginal tax rates on the real return on bank deposits which makes it harder for ADIs to compete for household savings. The tax concessions for bank deposits are a step in the right direction but do not go far enough.

Recommendation 35

15.18 The Committee recommends the taxation arrangements applied to bank deposits and mutual ADI deposits should be reviewed by the inquiry into the financial system.

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10 Mr David Foster, Chief Executive Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 2.

11 Australian Bankers' Association, *Submission 76*, p 53.

12 Australian Bankers' Association, *Submission 76*, p 53.

13 ING Bank, *Submission 35*, p 4.

GST input taxing

15.19 GST input taxing refers to situations where there is no tax payable on the supply of input-taxed goods, but the tax previously paid in the supply chain is not refunded.[14]

15.20 The Henry Review observed that GST 'input taxation' of financial services advantages larger, vertically integrated companies. Many small credit unions rely on the industry body to provide services such as government and regulator relations, media representation, regulatory compliance systems and support, legal advice, business advisory services, research and market intelligence and systems to fight fraud and financial crime.[15]

15.21 Abacus claim that:

> Credit unions and building societies rely on outsourcing to obtain economies of scale and therefore carry a heavier GST burden than the major banks.[16]

15.22 This problem has been partly addressed by GST reduced input tax credits, but these refer only to credit unions not to mutual building societies.

Committee view

15.23 The Committee notes the concerns raised that the GST input taxing arrangements disadvantage mutual ADIs. It did not receive sufficient evidence to come to a definitive conclusion on this matter.

Recommendation 36

15.24 The Committee recommends that the Government require Treasury to review the GST input tax arrangements for mutual financial intermediaries having regard to the comments in the Henry Tax Review.

Franking credits

15.25 Franking credits arose from the introduction of dividend imputation. They are an 'organisation's share of tax paid by a company on the profits from which the organisation's dividends or distributions are paid'.[17]

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14 *Report on Australia's Future Tax System*, Part Two, December 2009, p 286.

15 Abacus, *Submission 53*, p 28.

16 Abacus, *Submission 53*, p 28.

17 Australian Taxation Office, *Refund of franking credits—frequently asked questions*, www.ato.gov.au/nonprofit/content.asp?doc=/content/17149.htm&page=3&H3 (accessed 21 March 2011).

15.26 Abacus note that while banks make a return to their shareholders in the form of dividends, mutuals make a return to their 'shareholders' (who are also their customers) in the form of lower loan interest rates, higher rates on deposits, low or no fees and better service. This places them at a competitive disadvantage in being unable to make use of franking credits:

> Mutual ADIs pay company tax just like listed banks but mutuals do not have the same capacity to distribute franking credits.[18]

15.27 One building society added that the stockpile of unusable franking credits could make it more vulnerable to takeover:

> These accumulated franking credits could be used against a mutual ADI in the event of a predatory takeover attempt by a listed entity. Such a predator could offer to pay a dividend that incorporates Heritage's accumulated franking credits as an incentive to encourage members to accept their unsolicited offer of acquisition. In real terms this enables a predator to use the funds of members to help finance an attempted takeover.[19]

15.28 Abacus go on to suggest Treasury explore some way of allowing mutuals to distribute a kind of franking credit.[20]

15.29 An alternative is to:

> …lower the amount of tax customer-owned financial institutions are required to pay by the equivalent amount of the franking credit.[21]

15.30 Asked about Abacus' comment, Treasury replied:

> Credit unions and mutual building societies that pay company tax and distribute profits to members can choose to have the same access to franking credits as other taxpayers (including banks). Credit unions and building societies that are liable to pay company tax are taxed as co-operative companies. The income tax law was amended in 2003…to make it easier for co-operative companies that distribute profits to members to frank those distributions. As a result of those amendments, co-operative companies can choose to frank distributions to members. Alternatively, they can make unfranked distributions and obtain a deduction for amounts distributed to members. The effect of these changes was to give co-operative companies that distribute profits to members the same access to franking credits as other companies (including banks), while maintaining the long standing benefit of a deduction for unfranked dividends. Where

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18 Abacus, *Submission 53*, p 27. Similar points are made by the Heritage Building Society: *Submission 113*, p 8.

19 Heritage Building Society, *Submission 113*, p 8.

20 Abacus, *Submission 53*, p 27. A similar argument is made by Credit Union Australia: *Submission 85*, p 11.

21 Credit Union Australia, *Submission 85*, p 11. Again, a similar argument is made by Heritage Building Society, *Submission 113*, p 8.

> profits are not distributed to members due to legal, practical or other reasons franking credits are retained in the co-operative. If these franking credits were to be distributed to members (in the absence of a dividend), co-operative companies would obtain an advantage over other companies.[22]

15.31 Abacus responded:

> All credit unions and building societies, except for a handful of very small credit unions, are liable to pay company tax but Abacus is unaware of any credit unions or building societies that are taxed as co-operative companies. It is the case that credit unions and building societies may be able to elect, from year to year, to be taxed as co-operative companies, but to do so they would have to satisfy certain criteria. The fact that most, if not all, credit unions and building societies do not elect to be taxed as cooperative companies indicates there are significant barriers to doing so. Despite paying company tax like our listed bank competitors, credit unions and building societies are unable to provide franked returns to their owners. For example, should a mutual choose to pay a cash dividend, the level and type of dividend is tightly constrained by ASIC Regulatory Guide 147. The result is that credit unions and building societies continue to accumulate franking credits but cannot pass on the benefits.[23]

Committee view

15.32 The Committee agrees with the mutual ADIs that they are being disadvantaged by the current arrangements governing franking credits.

Recommendation 37

15.33 The Committee recommends that the Government require Treasury to review the treatment of building societies and credit unions in the franking credit arrangements and report publicly on the advantages and disadvantages of various options.

LIBOR Cap

15.34 A foreign bank drew attention to the foreign bank branch rules of the *Income Tax Assessment Act 1936*, under which the tax deductibility of interest paid by a branch on borrowings from its parent is limited to the London Interbank Offered Rates (LIBOR). When funds are provided at a rate in excess of the applicable LIBOR rate, the excess is denied a tax deduction:

> In response to the GFC, banks have been had to seek longer term funding (3 years or longer) throughout the last few years. This will continue into the future as a consequence of current requirements by APRA as well as their

22 Department of the Treasury, *Responses to questions on notice, no 14*, 4 February 2011, pp 2-3.

23 Abacus, *Supplementary Submission 53a*, p 2.

> intended future adoption of the recently published Basel liquidity pronouncements. LIBOR does not prescribe any rates for lending terms of greater than 12 months. Hence, the tax deductibility of borrowing costs of longer than 12 months is artificially capped at the LIBOR 12 month rate.[24]

15.35 The ABA also supported this:

> …removing the LIBOR cap on deductibility of interest paid on branch/head office (which includes branch-branch) funding, this reform will address tax constraints related to offshore borrowings. Under the foreign bank branch rules of the income tax law, deductibility for interest paid by the Australian branches of foreign banks on funds borrowed from their offshore branches/head office is limited to the London Interbank Offered Rate (LIBOR). Funds provided at a rate above LIBOR are denied a deduction for those amounts. During the GFC, the difference between LIBOR and commercial rates significantly widened. This reform would ensure that banks operating in Australia have access to alternative funding sources at competitive rates.[25]

15.36 Both the Johnson Report and the Henry Review recommended the abolition of this cap.

Recommendation 38

15.37 The Committee recommends that the Government require Treasury to review the abolition of the LIBOR cap to the tax deductibility of interest paid by a foreign bank branch on borrowings from its parent bank.

Retirement Savings Accounts

15.38 Retirement Savings Accounts (RSAs) are a capital guaranteed product offered by licensed ADIs, life insurance companies and prescribed financial institutions for retirement savings as a low risk/low income accumulation account.[26]

15.39 The Cooper Superannuation Review recommended they be phased out:

> RSAs have generally not been a success because they are a capital guaranteed product and there is currently no scope in the RSA framework for adding a market-linked investment where the risk of loss is borne by the holder. RSAs are thus suitable only for individuals with an extremely low risk tolerance, and are essentially unsuitable for much of the accumulation phase of retirement saving.[27]

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24 Citi, *Submission 116*, p 3. A similar argument is put by HSBC, *Submission 107*, p 4.

25 Australian Bankers' Association, *Submission 76*, p 54.

26 *Super System Review: Final Report*, June 2010, part 1, p 115.

27 *Super System Review: Final Report*, June 2010, part 2, pp 321-2.

15.40 Abacus takes issue with the Cooper Review's opinion that RSAs 'seem not to meet the low-cost objective for which they were originally intended':

> …in fact credit union RSAs are very low cost, with very few fees and very low fees.[28]

15.41 Abacus argue that with only one bank having shown interest in providing RSAs, it is an area where mutuals are filling a gap in the market and promoting competition.[29]

Committee view

15.42 The Committee supports the retention of retirement savings accounts. They offer mutual ADIs a useful avenue for competing with the banks.

First Home Saver Accounts

15.43 First Home Saver Accounts (FHSAs) were established in 2008 to assist first home buyers save a deposit. An individual who makes a contribution of $5,500 to their FHSA will be eligible for a Government contribution of $935 and FHSA earnings are taxed at a concessional 15 per cent.

15.44 The Government estimated in 2008 that by 2012 they would hold savings of $6,500 million, but by mid-2010 there was only $114 million in 22,600 accounts.

15.45 Only 19 ADIs offer the accounts.[30] It is generally thought that the reason they have not become more popular is that they require savings to be locked up for four years.

15.46 Abacus suggest means by which competition in this part of the deposit market could be invigorated:

> We have no doubt that the key problem with FHSAs is the four-year minimum qualifying period. The most consistent issue that appears in feedback to Abacus from credit unions and building societies about FHSAs is that the four-year 'lock-up' requirement is too long and is the single most important disincentive for savers. Abacus recommends removal or reduction of the period of time during which savings in FHSAs can't be withdrawn. The Government contribution is incentive enough to ensure that savers contribute over a number of years. A minimum period is an

28 Abacus, *Submission 53*, p 18.

29 Abacus, *Submission 53*, p 18.

30 Abacus, *Submission 53*, p 19.

> unnecessary disincentive and penalises savers who have the opportunity to buy a house within the 'lock-up' period.[31]

Committee view

15.47 Given the purpose of the First Home Saver Accounts scheme, the Committee regards it as appropriate for the savings to be locked up for four years.

Recommendation 39

15.48 The Committee recommends that the Government require Treasury to review the operation of the First Home Savers Accounts scheme and report publicly on the advantages and disadvantages of various options.

Increasing taxation on banking

15.49 As noted above, it is at least arguable that banks make larger profits because of their market power and implicit or explicit government backing. This has therefore led to calls for higher taxes to capture more of the excess profits for the people:

> …if the parliament is unable or unwilling to regulate to drive either actual competitive outcomes or price restrictions, we should consider a super profits tax on banks. We have just surveyed the public about the upcoming tax summit next year, and 81 per cent of Australians support the tax summit considering the introduction of a super profits tax on banks.[32]

> …banks make enormous profits not necessarily because they are particularly good at what they do but because they have the privilege of owning a bank license, have a large customer base and so have access to the clearing system and the cheap funds as part of their role in the payments system.[33]

> … implicit Social Licence to operate as facilitators of transactions, deposits and lending, should not be provided for free. The major Banks can rely on support from the Government, including from a regulatory and funding point of view…the implicit Social Licence held by the Major Banks [should] be made explicit in a fee calculated as a percentage on assets (ie. Loan portfolio), and paid by the Major Banks to the Government…a reasonable level would be one (1) basis point, payable per annum on total assets, by profitable Major Banks. For the Banks that are most profitable, measured in terms of return on equity, a higher rate should apply.[34]

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31 Abacus, *Submission 53*, p 19.

32 Dr Richard Denniss, Executive Director, Australia Institute, *Committee Hansard*, 15 December 2010, p 29.

33 Australia Institute, *Submission 46*, p 7.

34 Yellow Brick Road, *Submission 101*, p

15.50 Professor Buckley argues that the taxpayer should be compensated for the support to banks that will not be allowed to fail:

> Yet if Australian taxpayers are, in effect, standing behind our banks, and the banks' credibility in the marketplace is thereby strengthened and their cost of funds correspondingly reduced (for which there is considerable evidence), there is a very strong equity argument for a levy on bank assets.[35]

15.51 Other submitters opposed this suggestion:

> Banks are not analogous to mining companies – they are not depleting non-renewable resources and should not have a super profits tax imposed on them.[36]

> The fact that banks make large profits is another charge made against them, but the question is, 'Are these what are called "super profits"?' This term was introduced in the discussion of the resources rental tax. Super profits are profits above those necessary to keep the shareholders happy. Economists also call super profits 'rent'. Unfortunately, too many commentators assume that any profits at all are super profits and should be taxed away, taken away or regulated away.[37]

Committee view

15.52 The Committee notes that banks pay large amounts of company tax, which rises as their profits increase. It does not support calls for increased taxation on banks. Rather it wishes, through the earlier recommendations in this report, to increase the amount of competition in banking which will drive down bank profits to a normal level commensurate with their size and the riskiness of their activities.

Senator David Bushby | **Senator Alan Eggleston**
Chair, Banking Competition Sub-Committee

35 Professor Ross Buckley, *Submission 32*, p 5.

36 Dr Carolyn Currie, *Submission 114*, p 3.

37 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p. 61.