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24 June 2010

Manager
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The Treasury
Langton Crescent
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Email: capitalprotectedborrowings@treasury.gov.au

Dear Sir

Exposure draft - Changes to the Taxation of Capital Protected Borrowings

The Taxation Institute of Australia refers to the exposure draft released on Tuesday, 11 May 2010 in relation to the above matter.

The Institute would like to endorse the Australian Financial Markets Association submission that was lodged with Treasury on 14 June 2010 (refer attached).

If you require any further information or assistance in respect of our submission, please contact David Williams on 02 9958 3332 or the Taxation Institute's Tax Counsel, Angie Ananda, on 02 8223 0011.

Yours sincerely

D Williams

David Williams
President

14 June 2010

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Dear Sir or Madam

Exposure Draft – Changes to the Taxation of Capital Protected Borrowings

AFMA appreciates the opportunity to respond to the exposure draft legislation on the taxation of capital protected borrowings for consultation on the technical aspects of the amendments. Our membership includes the major issuers of the affected products.

AFMA agrees with the Government it is necessary to increase the benchmark interest rate that applies to capital protected borrowings from that announced in the May 2008 budget. However, we are concerned that the size of the proposed increase is too low to reflect the reality of the market and, therefore, is at odds with the policy objectives of the legislation. This outcome will disadvantage many ordinary taxpayers who invest in capital protected products. Moreover, it will require additional amendments to Division 247 to provide an integrated package of changes that is necessary for government policy to be implemented effectively.

We therefore submit that the benchmark rate should be set at a rate at least equal to the margin loan interest rate (published by the Reserve Bank) in order to better reflect the true economic cost of providing such loans and the policy intent of the provisions (noting that interest expense on margin loans is not limited by Division 247).

The key points in our submission are:

- The theoretical model of capital protected borrowings that underpins the Government's budget announcement does not properly reflect the real market. As a result, the proposed benchmark interest rate is set too low.

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- Legislating the benchmark interest rate as the home loan rate plus 100 basis points will both change the role of the benchmark interest rate within the workings of the law and effectively extend the practical application of Division 247 to many more financial products than it is currently designed to deal with. Consequently, it will be necessary to amend other parts of Division 247 to ensure that the law works effectively, including amendments to:
    - Exclude situations where a geared investor acquires a separate and fully priced (ie arms length) put option; to satisfy the stated objective of the law in excluding explicit put options;
    - Exclude loans to finance small and large businesses;
    - Specifically exclude employee share schemes that involve an employee share trust;
    - Differentiate between situations where the level of capital protection is significant and those where it is trivial;
    - Provide issuers with the option to price the implied loan or put option in accordance with the economics of their particular product for tax purposes;
    - Revise the Method Statement to calculate amount attributable to capital protection to accommodate partial repayments of a borrowing.

In the absence of these measures, the law will not operate in an integrated and effective manner under the scenario of the proposed benchmark interest rate. As a result, investors in capital protected borrowing products will face higher tax compliance costs and activity in the market will remain depressed below normal levels due to the tax penalty incurred by investors. The level of tax uncertainty will also increase.

1. Market Background

The impact of the May 2008 budget announcement on the market for capital protected borrowings has been harmful and the announcement in the May 2010 budget announcement is highly unlikely to reverse this effect.

Investors in instalment warrants, protected equity loans and other capital protected borrowing products are largely from what is sometimes called 'middle' Australia. For instance, instalment warrant application sizes vary, with an average of around $10,000 - $20,000 for some issuers, but applications are often for amounts as small as $2,000. This reflects the simplicity and well accepted structure of instalment warrants that makes it easier for both advisers and clients to understand them. Many investors, particularly those planning ahead for their financial needs in retirement, are looking for ways to invest in the markets and value the peace of mind capital protection provides, particularly at a time of heightened investment risk and volatility of markets. Whilst not the main driver, a reasonable tax treatment of capital protected borrowing products enhances their ability to meet investors' financial goals.

The adverse impact of the May 2008 budget announcement on the market is evident in Reserve Bank data for protected equity loans, the amount of which has declined steadily since the Budget announcement. In contrast, the

market for margin loans has picked up noticeably from its low point in June last year with a record number of accounts opened in 2010 and lending increasing. This outcome is the opposite of what would be expected under normal tax conditions, as investor risk aversion would have increased due to the global financial crisis.

	Protected equity loans	**Margin loans**	**Client accounts**
	$mn	$mn	'000
Jun-2008	2,903	28,986	206
Dec-2008	2,876	18,217	201
Jun-2009	2,359	15,909	199
Dec-2009	2,009	17,229	233
Mar-2010	1,952	17,222	222

2. The Benchmark Interest Rate

The Government announced in the May 2010 budget that the benchmark interest rate that applies to capital protected borrowings entered into after 7:30pm on 13 May 2008 will be adjusted to the Reserve Bank of Australia's Indicator Rate for Standard Variable Housing Loans plus 100 basis points.

While the increase from the rate announced in the May 2008 budget is welcome as a step in the right direction, the proposed rate falls well short of the economic rate that would be required to compensate lenders for their cost of funds and assumption of risk in respect of the underlying loan. The market is not 'frictionless' in the manner that the theoretical underpinning of the Government's decision would seem to suggest.

We have discussed these matters with Treasury officials on a number of occasions since May 2008 but, on the basis of those discussions, we are unaware of a policy or market based argument that would support such a low benchmark rate. To the contrary, we understood there was agreement that the assumption made in the initial technical analysis that the 'underlying loan' in a protected equity loan is risk free is wrong; indeed, it is easily demonstrated that the lender does take on a significant credit risk, if only because the implicit option premium is amortised and not paid for up-front (contrary to all conventional options).

In addition, the scale and institutional structure of the market for capital protected borrowings (including the participant range and intensity of competition) is markedly different to that of the home loan market. These factors require a significantly higher interest rate margin than is observed in the home loan market to cover associated costs.

Banks that offer both margin loans and protected equity loans assess the latter as posing greater credit risk (as distinct from the market risk attached to the implied put option). Moreover, in terms of scale, the margin loan market is nine times the size of the protected equity loan market, so the administrative cost of maintaining the loan and managing the risk is relatively higher in the protected equity loan market. Weighing these factors together, to set a benchmark interest at anything less than the margin loan interest rate is not credible (noting that interest expense on margin loans is not

limited by Division 247). Indeed, there is a strong economic and policy justification to adopt a rate significantly higher than the margin loan rate.

We would be happy to provide further information to Treasury to assist it develop a policy framework that more accurately reflects the nature of the market. We think this would be consistent with our previous contributions of information on products, risk management cost data and interest rate levels and trends. The legislation will be fundamentally flawed if the proposed amendments are legislated in their current form.

3. Legislative Consequences of Adopting a Low Benchmark Interest Rate

If the Government maintains that the benchmark interest rate will be reduced to the home loan rate plus 100 basis points, this will in effect extend the scope of Division 247 to a much wider range of financial products and it will be necessary to amend other parts of Division 247 to ensure that the law will work as intended.

Another consequence of legislating an unreasonably low benchmark interest rate is that taxpayers who invest in capital protected borrowing products will be treated inequitably, which will embed a tax bias against capital protected products in favour of riskier geared investments (for which interest expenditure is generally fully deductible). Other equally serious problems are higher taxpayer compliance costs and the inability of the existing law, through the provisions in Division 247, to meet the stated objective of the law.

3.1. Tax Law Design

When the Division 247 provisions were enacted in 2006, the personal unsecured loan rate as the benchmark interest rate was adopted as a specific design feature of the law. In other words, the level of the benchmark rate interacted with the other provisions in Division 247 to produce the desired policy outcome. In particular, it was made clear to AFMA by Treasury and the Minister's office during consultations that the effectiveness of Division 247 in meeting its objective depended on a benchmark interest rate that would exclude a range of normal and uncontroversial loan arrangements for business and individuals.

Consequently, there are areas where the provisions in Division 247 have not been developed to operate effectively alongside a benchmark interest rate that is much lower than the personal unsecured loan rate. This includes:

i. An exceptionally broad definition of capital protected borrowing, which both bifurcates and aggregates financial products to bring them within scope of Division 247;

ii. The absence of provisions to permit the exclusion of loan and option arrangements that are separately priced and independent of each other; and

iii. The application of Division 247 to business loan arrangements.

3.2. The Proposed Change in the Purpose of the Benchmark Rate

We think it is important to recall that the purpose of adopting a benchmark rate in legislation in 2006 was to provide a pragmatic and sensible solution to a theoretical problem that would otherwise be impossible to implement in a sensible manner. The alternative, conceptually 'pure' approach involves determining a unique interest rate for tax deductibility for each and every transaction of the many thousands of transactions that occur involving a potential capital protected borrowings.

AFMA agrees that the benchmark rate is the only sensible way forward. However, this presumes that the benchmark interest rate is an average rate in terms of the product spectrum, so while individual products may fare better or worse under the benchmark rate than they should do in a pure conceptual sense, a pragmatic balance that is achieved delivers a more efficient and less costly outcome for all involved. A significant problem with the proposed benchmark interest rate is that it sets the benchmark rate at the absolute lower end of the spectrum from which rates should be compiled to form the average and, thus, it would lose this averaging capability. This changes the nature and role of the benchmark rate.

In effect, the proposed benchmark rate unwinds the rationale for a benchmark rate and undermines a core element in the construction of Division 247. If this approach is implemented, then balance and fairness would require that product issuers be given the option to determine that the cost of providing their underlying loan in a capital protected borrowing is at a level greater than the legislated benchmark rate, or alternatively that the cost of providing their protection is at a level less than that estimated under the benchmark interest rate. ATO as the tax law administrator would have the ability to challenge the issuer's determination if they felt this is necessary. In other words, the benchmark interest rate would serve as a minimalist safe harbour.

While we think this outcome would be a dreadful turn of events from the point of view of tax system efficiency at the operational level, it would be a necessary step to counter the significant adverse effect of an unduly restrictive benchmark interest rate. This option would only be utilised by issuers in situations where they can demonstrate the necessary cost elements of their particular product and the cost of undertaking this analysis and obtaining sufficient tax certainty is exceeded by the benefits accrued.

A law change will be required to permit issuers to rely on their specific product cost features to determine the associated level of interest expense deductibility. We recommend that consultation involving Treasury, ATO and product issuers should be undertaken to develop a detailed set of practical operating rules and procedures.

3.3. Broad Definition – Aggregation Issues

The objective of the Division as presented in s.247-1 states:

> *"Capital protection provided under a relevant capital protected borrowing to the extent that it is not provided by an explicit put option is treated (for the borrower) as if it were a put option."*

Issuers of capital protected products are concerned that the operating provisions in Division 247 do not give effect to this objective because, as the law is administered by ATO, they capture situations where a geared investor acquires a separate, arms length priced explicit put option. While the consequences of this deficiency in drafting the law may be tolerable when the unsecured personal loan rate is the benchmark interest rate, this is not the case under the much lower benchmark rate proposed in the exposure draft legislation.

Example 1 - Hedging a Margin Loan Investment

The cost of the deficiency of the law identified above is significant in practice because there is a broad range of situations under which there is unacceptable risk that Division 247 would be applied in a way that would effectively constrain retail investors' ability to manage their investment exposures.

For instance, if Client A acquires an explicit put option from Bank X that is priced at market rates to protect at some level the value of shares it has acquired using a margin loan from Bank X (eg a stop loss), then this would be expected to be treated as a single arrangement under Division 247 as it is applied by ATO. The Division will firstly aggregate the independent loan and option products into a single arrangement and then divide that arrangement into two separate parts in a way that will disadvantage the investor from a tax perspective (as the new benchmark interest rate is less than the margin loan interest rate).

There is no economic or policy justification for this approach. To the contrary, we believe this outcome is at odds with the Government's policy objectives to promote sound risk management practices by retail investors, especially given the bad experience of Opes Prime and Storm Financial, amongst others. Oddly, if the investor were to independently acquire a similar option from Bank Y, then we understand that ATO[1] would agree that its margin loan interest expense would remain fully deductible!

Example 2 - Acquiring a Capital Protected Product

Issuers of capital protected borrowing products have sought confirmation from ATO that s.247-10 should not be read as extending the application of Division 247 to products where the capital protection is not embedded in the loan (rather the capital protection is a feature of the underlying instrument purchased with the proceeds of the loan or that is offered as security). This approach would give a sensible application of the law in practice and is also

[1] Consistent with example 7.4 in the Explanatory Memorandum of Tax Laws Amendment (2006 Measures No. 7) Bill 2006.

consistent with statutory interpretation. It is important because a wide range of investment products offer some degree of capital protection.

If the ATO does not provide the anticipated guidance, then Division 247 would have to be amended to remove any doubt about the exclusion from Division 247 of a full recourse loan applied to acquire a capital protected product. The definition of capital protected borrowing should only include situations where the capital protection is provided by the lender under the terms of the borrowing agreement or where the protection is made available by the lender, or a third party, only to investors who have a relevant borrowing on terms that are not arms-length.

This approach would be consistent with the stated policy intent of the measures and would pose no risk to tax revenue. Moreover, Part IVA of the Tax Act would apply to situations where a contrived outcome is designed in order to defeat the intent of the law.

3.4. Broad Definition – Business Loans

During consultations in the lead up to Tax Laws Amendment (2006 Measures No. 7) Bill 2006, AFMA was advised that it is not the policy intention to capture project finance and other business finance transactions under Division 247. This is because these transactions do not pose a risk to tax revenue in this context and also because there would be a cost to economic performance if tax deductions for interest payments on business investment were limited in this manner.

Nonetheless the law was not written to limit its application to retail investors only – we understand this was done to avoid the technical challenge of distinguishing between retail investors and business for the purpose of this part of the law. This apparent inconsistency was resolved by excluding a wide range of common loan products because their interest rates fell comfortably below the unsecured personal loan rate and also because of targeted limitations on the application of the Division in s247-15. Through these measures it was expected that Division 247 would not apply to limit interest expense deductions on borrowings by business.

However, the extraordinarily broad definition of a capital protected borrowing in s.247-10 does capture common business loan arrangements. For example, consider a small business that holds financial assets on its balance sheet as part of a strategy to manage its liquidity and investment needs, including a small share portfolio which is partly capital protected. If this business enters a full recourse loan with a bank to acquire new equipment, then Division 247 will deem there to be a capital protected borrowing in place – s247-10(2); "the borrower uses the protected thing as security for the borrowing or provision of credit".

Since the small business loan rate is 9.35% compared to the standard variable home loan rate of 7.4%, the business would be denied over 10% of their interest expense as a tax deduction under the proposed benchmark

rate.[2] Interest would be deductible in full if either the margin loan rate or the unsecured personal borrowing rate were used as the benchmark interest rate.

There are a number of ways to deal with this problem. The best solution (other than a higher benchmark rate) is to effectively confine the application of the measures to the retail market – this would better target the measures at the primary revenue concern, as companies are not eligible for a reduced CGT rate. This would involve a change to the law.

3.5. Broad Definition – Level of Protection Issues

The application of Division 247 is significantly extended in practice by the fact that any level of capital protection for a relevant asset held by a company or person seeking finance on a full recourse basis (or on a limited recourse basis that include any amount of protected shares as collateral or security) will trigger the application of Division 247. In other words, the law quite explicitly does not differentiate between a loan for which the underlying security is 1% capital protected and a loan for which the underlying security is 100% capital protected.

By its very nature, this gives rise to unfair and unreasonable outcomes for certain classes of taxpayers. In particular, borrowers who offer for security relevant assets that have a trivial amount of capital protection are treated in the same way under Division 247 as borrowers who have complete capital protection for their security assets. Obviously, the capital protection benefit would be marginal in one case and substantial in the other but Division 247 would deny the same amount of interest expense deductions in each case (assuming the same loan interest rate).

In addition, as a result of the failure of Division 247 to properly distinguish between different levels of protection, large and small business loan arrangements may be inadvertently caught under Division 247, many of which would consequently technically face denial of deductions for interest expenses legitimately incurred during the course of their business.

Again, this is a situation where the pre-May 2008 benchmark interest rate effectively overcame the majority of problems encountered in applying the law practice because it brought the focus to products that embody a significant element of capital protection. The new benchmark interest rate cannot fill the same role in filtering out regular loans that pose no mischief within the framework of government policy and, thus, it gives rise to much less efficient law.

3.6. Employee Share Plans

Employee share plans commonly involve either:

- Employees borrowing under a limited recourse loan to acquire shares (directly) which are subject to vesting; or

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[2] 10% allows for the proposed 100 basis point uplift to the home loan rate. Interest rates are taken from the Reserve Bank of Australia's website: http://www.rba.gov.au/statistics/tables/index.html#interest_rates

- A trustee of an employee share trust borrowing under a limited recourse loan to acquire shares and allocating the shares to the employees, subject to vesting.

There is a carve-out from the capital protected borrowing provisions in circumstances where both:

- An employee share scheme (ESS) interest is acquired under the borrowing; and
- Subdivision 83A-B or 83A-C applies to the interest: s.247-15(3).

This carve out appears to be drafted specifically for employees who borrow to acquire shares (directly).

There are some technical issues as to whether the carve-out can apply to a limited recourse loan entered into by the trustee of an employee share trust to fund the acquisition of the relevant shares. For example, although the trustee could be said to acquire an ESS interest (ie, the beneficial interest in a share) Subdivision 83A-C does not apply to that particular ESS interest – rather, that Subdivision applies to a different ESS interest (ie, the employee's beneficial interest in the relevant share).

There is no coherent policy basis for carving out borrowings by employees from Division 247 but not carving out borrowings by an employee share trust. Accordingly, an amendment to clarify Division 247 is necessary.

3.7. Other Changes

Term Repayments and Method Statement

The Method Statement in s.247-20 assumes that the loan remains outstanding in full over the life of the product, as it does not adequately cater for situations where the loan is repaid to some extent or is repaid early. This requires a technical amendment to the law.

Fixed & Floating Rate Provisions

Members have suggested that, as a law simplification measure, it is possible to consider a variable rate capital protected borrowing as a 1 day fixed rollover arrangements, thus obviating the need for separate variable and fixed rate provisions. This might be considered in the context of technical law changes that are being considered.

Interest Pre-payments

Members have suggested that there is some uncertainty around the treatment of pre-payments, particularly where the payment is made on 30 June. The proposed Section 247-20(4) and 247-20(5A) apply where the fixed rate or variable rate is applicable for all or part of the "income year". However, where an interest amount is prepaid on 30 June, the rate will be applicable only to one day of *that* income year and the large part of the remainder will be applicable to the *following* income year. We suggest this provision be clarified.

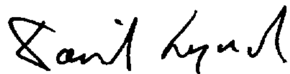
4. Concluding Comments

The substance of our comments above suggest that there is a gap between the industry's assessment of the economics of capital protected borrowing products and the analysis that underpins the Government's announcement on the benchmark rate. We would find it helpful to be given a briefing on the policy analysis behind the proposed change to the benchmark rate, including the effective expansion of the scope of the measures and the changed role of the benchmark rate. We think that insights gained through this discussion may assist with the further development of the law.

It is evident the proposed tax changes do not address many of the issues presented by adoption of the proposed benchmark rate. We believe that industry consultation should take place on the technical design of the additional measures that are necessary to support a fair application of the law and an efficient tax system.

Thank you for the opportunity to provide comments on the exposure draft legislation. Clearly, we believe further thought needs to be given to the design of the law if the proposed benchmark interest rate is to be legislated. Consistent with our approach to this part of law development for many years now, AFMA would be happy to contribute to the further work in this area.

Yours sincerely



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