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Interest withholding tax reduction: Does absence make the heart grow fonder?

Andrew Smailes¹

Abstract

The current trend in relation to interest withholding tax (IWT) is a decline in the application of such taxes. The Tony Abbott-led Coalition government has determined that it will not proceed with the further phase down of IWT, proposed in the Henry Tax Review. Thus this paper takes the opportunity to consider whether or not IWT phase down would be a worthwhile revenue reform. This paper concludes that, removal of IWTs potentially could be a positive step for corporate finance however the argument is more complex than simply one about increased investment. Furthermore, the opposite course could equally be justified.

Keywords: *Interest withholding tax*

The objects of a financier are, then, to secure an ample revenue; to impose it with judgment and equality; to employ it economically; and, when necessity obliges him to make use of credit, to secure its foundations in that instance, and for ever, by the clearness and candour of his proceedings, the exactness of his calculations, and the solidity of his funds

- Edmund Burke, *Reflections on the Revolution in France* (1790).

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1. INTRODUCTION

Australia's Future Tax System Review (the Henry Review) recommendations 33 and 34 are that “financial institutions operating in Australia should generally not be subject to interest withholding tax on interest paid to non-residents” and that “consideration should be given to negotiating, in future tax treaties or amendments to treaties, a reduction in interest withholding tax to zero so long as there are appropriate safeguards to limit tax avoidance”². As a result, this paper in part considers why in light of widespread austerity measures and concern over fiscal balance,³ not just Australia, but a number of other countries are voluntarily forgoing the revenue from interest withholding tax (IWT)⁴. While the Australian Government committed to phase down IWT from 2014–15 in its *Tax Reform Road Map* of 2012, no action has taken place in this direction thus far and it now appears unlikely that such action will occur in the near future.⁵ This delay presents an opportunity to pause and consider whether the current general trend of reduction and removal of IWTs is advisable in terms of efficiency, administration, commercial outcomes and overall revenue yield. For instance, one consideration that will be raised is that the removal of IWTs is unlike the removal of excises and taxes on trade (which is similar due to the international treaty and diplomacy aspects) because there is no reciprocal implementation of general consumption taxes to, in theory at least, replace forgone revenue.⁶ Instead, the major benefits of an IWT reduction are a more nebulous ‘multiplier’ or ‘trickle down’ effect of increased economic activity. Admittedly the revenue from IWTs is not on par with that from income taxes and broad consumption taxes, however most governments are raising taxes to pay for spiralling debt—so is a reduction or removal of IWTs opportune or ill-advised? These questions are complicated by the growing debate in regards to base erosion and profit shifting (or BEPS) and the introduction of final withholding taxes in Europe on investment earnings. While this paper does not provide sufficient scope to cover the wide and growing topic of BEPS and these new withholding taxes in intricate detail, IWTs will at least be placed in this broader context.

2. THE LEGAL FRAMEWORK OF IWT IN AUSTRALIA

IWTs are part of a dual framework of both domestic law and international treaty articles. Ultimately, however, domestic law is the starting point with treaty articles merely moderating the operation of IWTs. In Australia, the domestic law in relation

² Australia's Future Tax System Review, (2009), *Final Report*, Part Two, Volume One, p182.

³ Organisation for Economic Co-operation and Development (OECD), ‘International Capital Mobility: Which Structural Policies Reduce Financial Fragility?’ (2012) *OECD Economic Policy Papers* no 2.

⁴ Commonwealth Treasury, *International Comparison of Australia's Taxes* (2006); Hugh Ault and David Bradford, ‘Taxing International Income: An Analysis of the U.S. System and Its Economic Premises’ in Assaf Razin and Joel Slemrod (eds) *Taxation in the Global Economy* (1990); Zee, above n 4.

⁵ Commonwealth Treasury, *Tax Reform : Road Map* (2012). However, it should be further noted that one of the commitments of the Tony Abbott-led government is to not proceed with this phase down—J Hockey and A Robb, ‘Coalition's Responsible Budget Savings’ (Media Release 28 August 2013).

⁶ John Norregaard and Tehmina Khan, *Tax Policy : Recent Trends and Coming Challenges* (2007); Richard Bird and Eric Zolt, ‘The Limited Role of the Personal Income Tax in Developing Countries’ (2005) 16 *Journal of Asian Economics* 92; Richard Bird and Peirre Gendren, *The VAT in Developing and Transitional Countries* (2007); Cedric Sandford, *Why Tax Systems Differ : A Comparative Study of the Political Economy of Taxation* (2000).

to IWTs is Division 11A of the *Income Tax Assessment Act 1936* (Cth) (ITAA 36) which requires that IWT be imposed on any interest derived by a non-resident when that interest payment is made by an Australian resident.⁷ The rule is extended to include payments from non-residents where such payments are expenses of a permanent establishment in Australia. Conversely, there is an exemption from IWT in relation to interest payments by residents as part of their permanent establishments offshore.⁸ An important point to note is that the use of the term ‘derived’ in this framework means that it covers not just interest paid but interest that is merely payable, such as interest that is reinvested.⁹ Finally, the rate of IWT is 10 per cent¹⁰ of the gross interest amount¹¹ which is important because, unlike income taxes which are based on net amounts, there is no concept of deductions.¹² This 10 per cent rate is merely the starting point and that in many cases, the rate is reduced by the operation of a tax treaty.¹³ The OECD Model Convention, on which most worldwide treaties are based, allows for the concept of IWTs however the underlying rationale is that the rate used should be as low as possible, if not nil.¹⁴ As a result, most treaties entered into by Australia since the 1980s include a sharp reduction of IWT, often to nil, in return for increased information exchange.¹⁵ The overriding goal is for portfolio interest invested worldwide to be subject to taxation only in the source country rather than the destination country.¹⁶

For the purposes of the IWT provisions, the definition of ‘interest’ is an important issue and one that is not as simple as it appears. Interest is defined as any amount in the nature of interest or any amount that could be reasonably regarded as being in substitution for interest, such as amounts under a washing arrangement,¹⁷ though returns on equity are specifically excluded.¹⁸ Thus, as per the definition of interest

⁷ *Income Tax Assessment Act 1936* (Cth), section 128B.

⁸ *Income Tax Assessment Act 1936* (Cth), section 128B.

⁹ Australian Tax Office (ATO), *Income Tax: Should a Resident Deduct Withholding Tax From Interest Payable Under a Loan From a Non-resident If There is No Actual Payment of the Interest?*, TD 93/146 at [2]—“the requirement to withhold the tax from the interest does not require an actual payment of the interest. It is enough if the interest liability arises”.

¹⁰ *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* (Cth), section 7.

¹¹ *Income Tax Assessment Act 1936* (Cth), section 128B.

¹² Johannes Jüttner and Norman Carlsen, ‘Taxing International Capital Income: Interest Withholding Tax’ (1998) 1(3) *Journal of Australian Taxation* 219; Zee, above n 4.

¹³ As in force under the *International Tax Agreements Act 1953* (Cth).

¹⁴ OECD, *Model Tax Convention on Income and on Capital—Full Version* (2010), Article 11.

¹⁵ Commonwealth Treasury, *Australian Tax Treaties Table* (2013); Jüttner and Carlsen, above n 12; Zee, above n 12. As with most other developed countries, see –Joanna Khoo, ‘Reducing Withholding Tax Rates in Double Tax Treaties : Trends and Implications’ (2009) 24 *Australian Tax Forum* 597.

¹⁶ Khoo, above n 15; Ewen McCann and Tim Edgar, ‘The International Income Taxation of Portfolio Debt in the Presence of Bi-Directional Capital Flows’ (2006) 4(1) *eJournal of Tax Research* 5; Jüttner and Carlsen, above n 12; Michael Dirks and Brett Bondfield, ‘Cataloguing International Tax Reform 12 Years On’ (2012) 27 *Australian Tax Forum* 25; Sylvester Eijffinger, Harry Huizinga and Jan Lemmen, ‘Short Term and Long Term Government Debt and Non-Resident Interest Withholding Taxes’ (1998) 68 *Journal of Public Economics* 309; Harry Huizinga, ‘The Incidence of Interest Withholding Taxes: Evidence from the LDC Loan Market’ (1996) 59 *Journal of Public Economics* 435; Alan Auerbach, ‘Taxation, Corporate Financial Policy and Cost of Capital’ (1983) 21 *Journal of Economic Literature* 905.

¹⁷ *Income Tax Assessment Act 1936* (Cth), section 128A (A washing arrangement involves the transfer and reacquisition of a corporate debt instrument so that the coupon payments are made to a tax advantaged entity while the original entity retains the capital interest).

¹⁸ *Income Tax Assessment Act 1936* (Cth), section 128A.

income for the general purposes of the ITAA 1936,¹⁹ the bright line as to whether an amount is interest is whether an amount is paid as a return on debt rather than equity.²⁰ In practice however, there are a range of exclusions from IWT²¹ which mean amounts which are clearly interest are not subject to IWT. For instance, IWT is not imposed on certain debentures offered to the public, government bonds and payments to offshore banking units.

IWT is a final 'income' tax for non-residents²² as amounts that are subject to IWT become non-assessable non-exempt income.²³ While the legal incidence falls on the non-resident, the resident payer is responsible for withholding and remitting the tax which is then credited against the non-resident's liability.²⁴ Should the payer not withheld the correct sum *and* remit said sum to the ATO, the payer effectively steps into the shoes of the non-resident and is potentially required to pay the IWT, penalty and interest.²⁵ A further incentive for the payer to withhold and remit the correct sum is that the interest payment is precluded from being a deduction till IWT is paid²⁶ and a civil penalty can also be imposed.²⁷ The effect of these incentives is that non-residents almost never pay IWT as payers withhold an amount at least equal to the likely IWT liability. This author goes so far as to say that payers of interest may even have an incentive to overestimate IWT payable, especially if there is any uncertainty about quantum of the IWT liability. As a result, a commercial practice is common whereby, to avoid such overestimation and maintain the underlying rate of return in a transaction, the borrower (resident payer) indemnifies the non-resident lender for any IWT payable²⁸. Interestingly, gross up amounts under such a practice are not classed as interest but may still be ordinary income.²⁹ Thus, in many cases IWT is first and foremost a concern for resident payers of interest rather than interest recipients. That is not to say however that IWT has no impact on the behaviour of non-resident lenders—there is an impact and this paper will address the issue shortly.

First, this paper will consider specific IWT implications³⁰ for resident financial institutions including authorised deposit-taking institutions (ADIs).³¹ Chiefly this is

¹⁹ *Income Tax Assessment Act 1936* (Cth), section 6.

²⁰ However, as readers familiar with the debt and equity rules in Australia in Division 974 of ITAA36 will note, the dividing line between debt and equity is never entirely easy to discern in practice.

²¹ *Income Tax Assessment Act 1936* (Cth), sections 128F, FA, GB.

²² *Income Tax Assessment Act 1936* (Cth), section 128D.

²³ *Income Tax Assessment Act 1997* (Cth), sections 6-23.

²⁴ *Taxation Administration Act 1953* (Cth), Schedule 1 section 18-15.

²⁵ *Taxation Administration Act 1953* (Cth), Schedule 1 subdiv 16-B.

²⁶ *Income Tax Assessment Act 1997* (Cth), sections 26-25; ATO, *Income Tax: Deductibility of Royalties Where Withholding Tax Has Not Been Remitted to the Tax Office* TD 93/99. Though this applies to royalties, the underlying principles are the same.

²⁷ *Taxation Administration Act 1953* (Cth), Schedule 1 section 16-25.

²⁸ *FCT v. Century Yuasa Batteries* (1998) 38 ATR 442; TR 2002/4 'Income tax: taxation implications of the Century Yuasa Batteries decision'; *David Securities Pty Ltd v Commonwealth Bank of Australia* (1992) 175 CLR 353; Richard Vann, 'International Aspects of Income Tax' in Victor Thuronyi (ed) *Tax Law Design and Drafting* (1998), 718 - 806.

²⁹ *FCT v Century Yuasa Batteries* (1998) 38 ATR 442; ATO, *Income Tax: Taxation Implications of the Century Yuasa Batteries Decision*, TR 2002/4.

³⁰ *Income Tax Assessment Act 1936* (Cth), sections 160ZZVA to 160ZZZJ and ATO, *Income Tax: Interest Withholding Tax—Cross-border Interbranch Funds Transfers Within Resident Authorised Deposit-taking Institutions*, TR 2006/9.

about the application of the permanent establishment rules in the IWT provisions because ADIs are rarely standalone entities but engage in borrowing at and through offshore and onshore establishments and branches.³² The task of tracing the end use of such dispersed borrowings to determine if one of the IWT exceptions applies is understandably difficult and an ATO ruling notes that ‘Where it is not possible ... the interest outgoing is, subject to paragraph 16 of this Ruling, reasonably attributable to income derived by that part of the ADI (for example, offshore PE or Australian head office) through which the funds were borrowed’.³³ Furthermore, where an Australian branch borrows from its foreign parent, the nominal interest (which is based on LIBOR³⁴) is subject to a five per cent IWT,³⁵ where the borrowing occurs from retail investors the rate is 10 per cent³⁶ and borrowings are exempt when they are sourced through public offers of debentures. Even with such rules of thumb, for many ADIs, the application of IWT is far from straightforward but certainly not insurmountable. More broadly, while the basic case is that IWT is a 10 per cent final tax on (all) interest payments to non-residents, there has been significant winding back of the application of IWTs in recent years. This trend is based on a certain rationale, present in the Henry Review which will now be explored.

3. HENRY REVIEW RECOMMENDATIONS

The basis of the Henry Review recommendations in relation to IWTs³⁷ is the fact that Australia is a capital importing country³⁸ and therefore relies on inbound finance which is often on-lent by larger financial institutions to other smaller market participants.³⁹ The Henry Review further points out that there is arguably an overall distortion in Australia in favour of debt over equity.⁴⁰ The Henry Review first introduces IWTs into its discourse because they may ‘moderate the bias against equity’⁴¹ though the Henry Review notes that this will be a minor effect.⁴² Turning to IWTs in more detail the Henry Review points out that IWT ‘will likely be passed onto Australian borrowers by way of higher interest rates on their borrowings—increasing

³¹ An Authorised Deposit Taking Institution (ADI) is an entity that has been granted a banking licence under the *Banking Act 1959* (Cth), and for Australian law is able to trade as a ‘bank’.

³² ATO, above n 30; see also Tricia Ho Hudson, Tony Frost and Julian Pinson, ‘Capital Management of Financial Institutions and Related Tax Issues’ (2013) 16(4) *The Tax Specialist* 138; Michael Keen and Ruud de Mooij, ‘Debt, Taxes and Banks’ (2012) *IMF Working Paper* 12/48; Tony Clemens, ‘Australian Taxation Aspects of Major Funding Transactions’ (2005) 8(5) *The Tax Specialist* 255.

³³ ATO, above n 30 at [15].

³⁴ London Interbank Offered Rate is the established standard for inter-bank loans.

³⁵ *Income Tax Assessment Act 1936* (Cth), sections 160ZZVA to 160ZZZJ.

³⁶ As per normal IWT rules outlined above.

³⁷ Australia’s Future Tax System Review, *Final Report* (2009).

³⁸ See also Australia’s Future Tax System Review, *Architecture of Australia’s Tax and Transfer System* (2008); Australia’s Future Tax System Review, *Australia’s Future Tax System Consultation Paper* (2008); Khoo, above n 15; Jüttner and Carlsen, above n 12.

³⁹ Australia’s Future Tax System Review, above n 38.

⁴⁰ Australia’s Future Tax System Review, above n 38; Graeme Cooper, ‘Implementing an Allowance for Corporate Equity’ (2012) 27 *Australian Tax Forum* 241; Grace Weishi, Ruud de Mooij and Tigran Poghosyan ‘Taxation and Leverage in International Banking’ (2012) *IMF Working Paper* 12/281.

⁴¹ Australia’s Future Tax System Review, above n 37 at 179.

⁴² Australia’s Future Tax System Review, above n 37.

their cost of capital and reducing domestic investment'.⁴³ Furthermore the exemptions built into the IWT provisions and the patchwork nature of Australia's treaties mean that there are distortions created by IWT between different methods of accessing and structuring foreign debt and between accessing debt from different countries.⁴⁴

The Henry Review goes on to state that on the other hand, IWTs can help prevent tax avoidance through off shore structures,⁴⁵ by reducing the benefits of such structures, and can provide valuable information for authorities to data match against.⁴⁶ The first of these points will become more relevant as this paper places IWTs within the overall BEPS debate. However, on balance, the Henry Review considered that the distortions introduced by IWTs favour a course of further reduction of IWT.⁴⁷ Therefore, the Henry Review recommended bilateral reduction of IWTs through treaties, and unilateral reduction of IWTs for financial institutions in Australia.⁴⁸ While there is no detailed justification given for why this unilateral reduction should only apply to financial institutions, it is perhaps possible to see why this is the case. Financial institutions, as noted previously, act as both capital importers in their own right as well as intermediaries for capital which is sourced overseas and re-lent domestically. While there is no IWT paid on this domestic borrowing, the IWT on the source of capital will generally already be priced in. Add this to the fact that financial institutions lend and borrow as their core business and have interest as one of their core expenses and it can be seen that financial institutions are perhaps the point of largest impact for IWTs. Thus, the Henry Review recommended a reduction of IWT largely due to the distortions that IWT causes, with further reference to the cost of capital and impacts on investment levels. However this course of action is perhaps not as straightforward as the Henry Review presents it in light of new developments with BEPS and with final withholding taxes now introduced in Europe.

4. IWTs—REVENUE IMPACTS

The starting point for this evaluation of the trend in favour of removal and reduction of IWTs is the revenue outcomes of the tax. In Australia, IWTs account for a comparatively small amount of revenue as shown below.⁴⁹ This is a situation

⁴³ Australia's Future Tax System Review, above n 37 at 180.

⁴⁴ Australia's Future Tax System Review, above n 37.

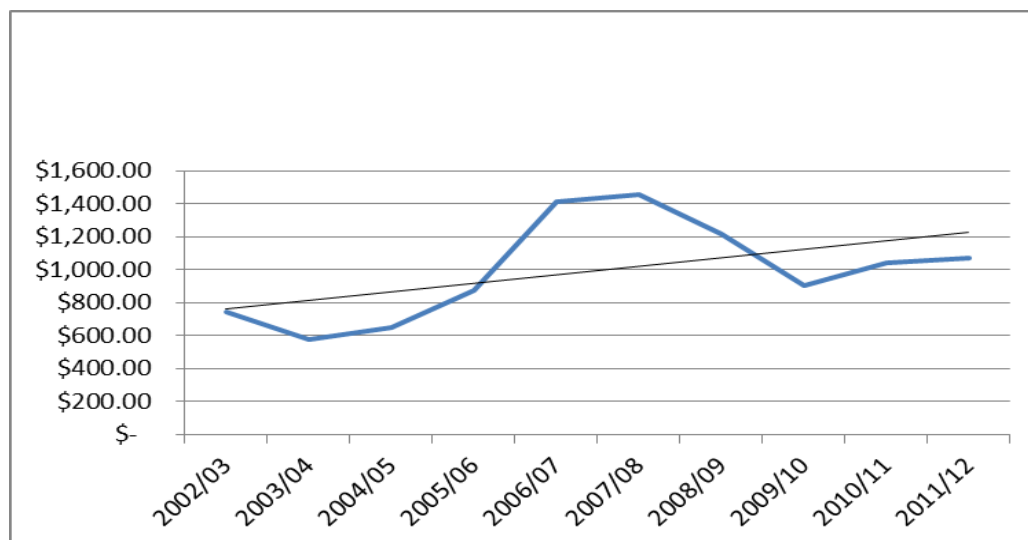
⁴⁵ Jüttner and Carlsen, above n 12; Zee, above n 4.

⁴⁶ Ibid.

⁴⁷ Australia's Future Tax System Review, above n 37.

⁴⁸ Ibid, 182.

⁴⁹ Data from Australian Bureau of Statistics (ABS). ABS, 2013, *Taxation Revenue, Australia, 2011-12*, cat. no. 5506.0, ABS;; see also Jüttner and Carlsen, above n 12.

Figure 1: IWT collections in Australia (\$mill)

that is common throughout OECD countries.⁵⁰ However, though the direct revenue value of the tax (at or just over only \$1 billion in the last few years) is low the trend over the last ten years has actually been an increase in IWT collections in Australia. However, making a judgement on this fact alone would be an error. As further data from Australia's balance of payments below shows, the total interest debits overseas during the same period has increased at a far greater rate.⁵¹ Such interest payments are the theoretical base of the IWT. If collections and interest debits are compared it is possible to determine an approximate effective rate of IWT in Australia once all exemptions are factored in. The result of this analysis, shown below, potentially indicate that the effective rate of IWT in Australia is just below three per cent, and declining.⁵²

⁵⁰ Commonwealth Treasury, *International Comparison of Australia's Taxes* (2006); Ault and Bradford, above n 4; Zee, above n 4; OECD, 'Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series 2010' (2011).

⁵¹ Data from ABS. ABS, 2013, *Balance of Payments and International Investment Position, Australia 2011-12*, cat. no. 5302.0, ABS.

⁵² See also Jüttner and Carlsen, above n 12.

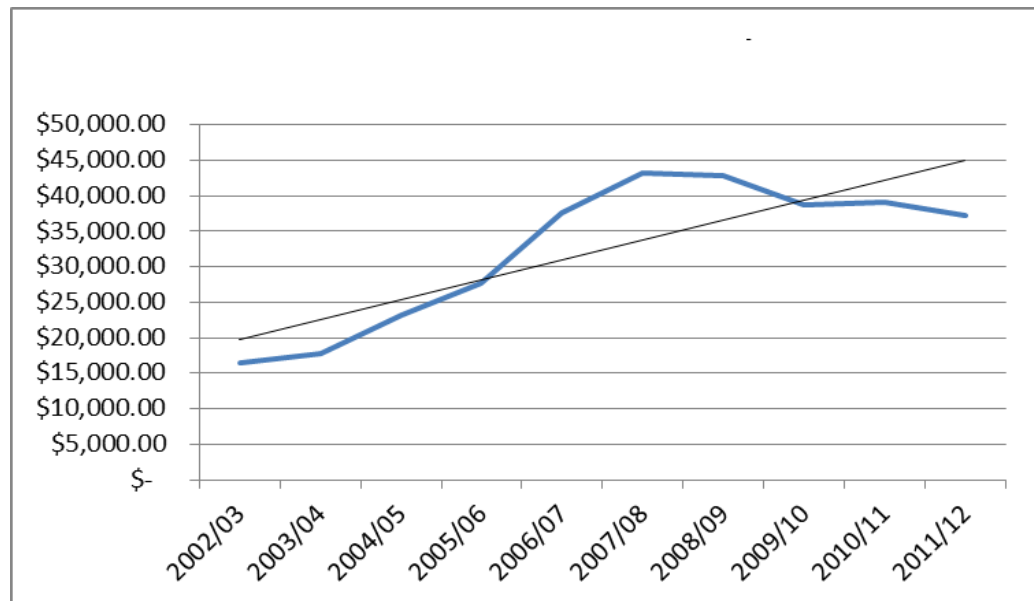
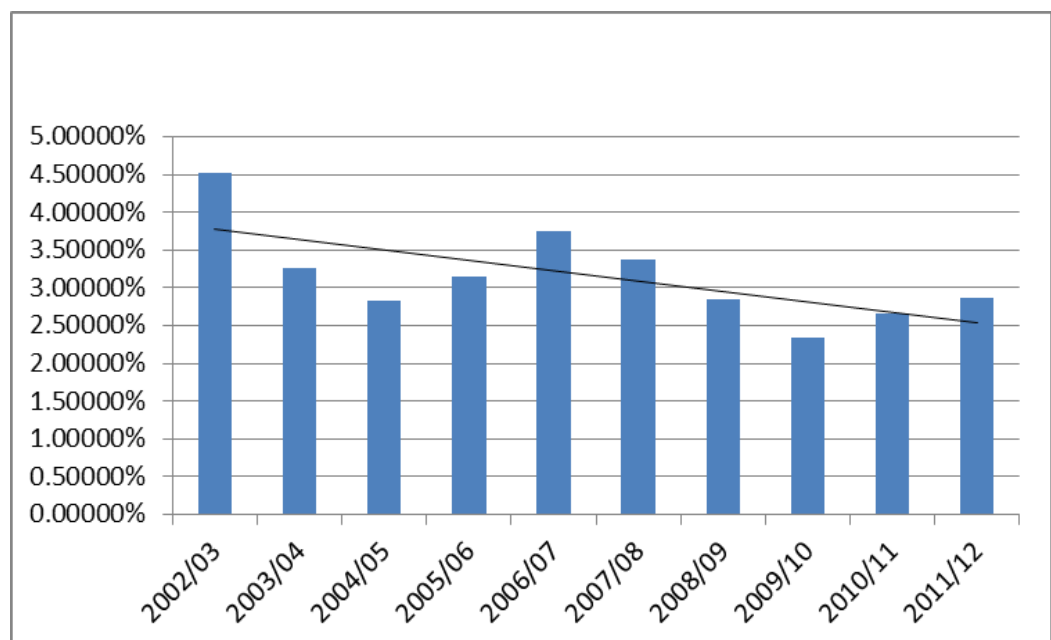
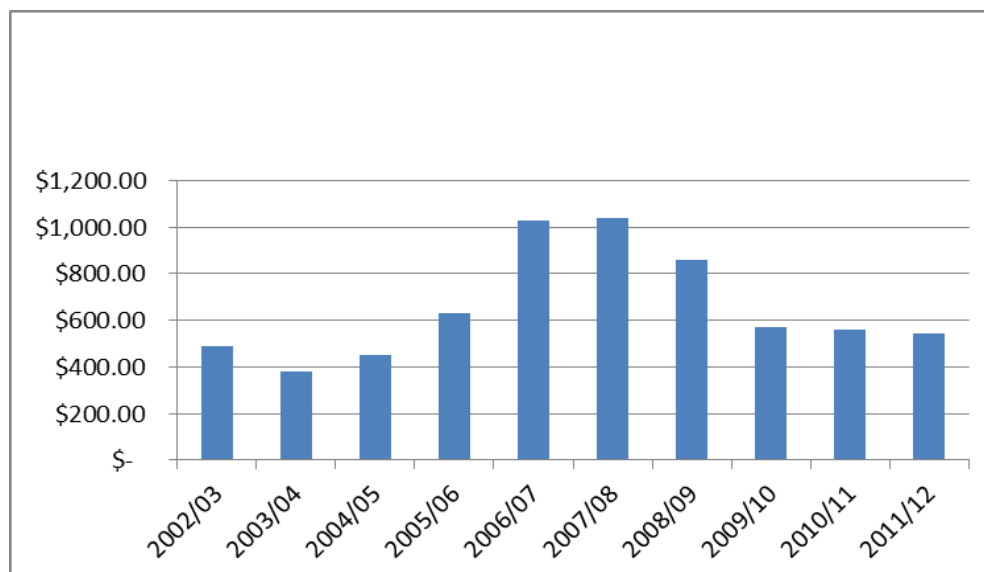
Figure 2: Interest debits (\$mill)**Figure 3: Effective IWT tax rate**

Figure 4: Estimated IWT collections from financial institutions

Further, if this approximate effective rate is applied against the interest debits from financial institutions alone,⁵³ the IWT collected from financial institutions over the last 10 years would vary between below \$400 million and over \$1 billion, which gives an indication of how much of the underlying IWT revenue is provided by financial institutions which are targeted for further exemptions under the Henry Review. Thus, over the last decade, in Australia an average of \$996 million in revenue per annum has come from IWT, including an estimated \$654 million from financial institutions per annum on average.

Thus, even if IWTs were entirely removed in Australia, the absolute revenue impact would be comparatively minimal.⁵⁴ That is not the point of tax reform, which is generally required to be revenue neutral. Generally, any revenue forgone under tax reform should be matched by compensating benefits, either in the form of increased direct revenue from other taxes or improved equity, efficiency or other substantive (though not necessarily monetary) outcomes which lead to greater overall welfare. This is an implication of the key requirement of revenue buoyancy.⁵⁵ Even though removing IWTs would not have a significant direct impact on revenues, as a matter of principle there must be some compensating factors for revenue forgone.

5. COMPENSATING FACTORS FROM A REMOVAL/REDUCTION OF IWT

The often stated reason for removal or reduction of IWTs is minimising the distortions they cause.⁵⁶ There are effectively two actors who are party to IWT imposition that

⁵³ Data from ABS, above n 51.

⁵⁴ Jüttner and Carlsen, above n 12.

⁵⁵ Sandford, above n 6.

⁵⁶ Dirkis and Bondfield, above n 16; Lawrence Goulder, 'Implications of Introducing U.S. Withholding Taxes on Foreigners' Interest Income' in Summers, Lawrence (ed) *Tax Policy and the Economy* (1990), 103 - 140; Zee, above n 4.

may have their behaviour distorted; the non-resident investor and the resident recipient of finance. For the investor, provided that the IWT is fully creditable and that the credit can be fully used to offset other tax (which is a common outcome)⁵⁷, there is no immediate change to after tax return.⁵⁸ Thus in the majority of cases, if not the substantial majority, the after tax return of the investor is not immediately affected.⁵⁹ However, the conclusion that the investor will be “indifferent”⁶⁰ is perhaps a step too far. Even in the best case scenario when the investor obtains a dollar for dollar credit that is fully ‘valuable’ to them, there is arguably a timing distortion⁶¹ as the offshore investor does not generally obtain the benefit of the IWT credit until they lodge and pay tax in their country of residence, which may be months after the IWT is withheld.

Table 1: Illustration of different withholding tax scenarios for lender

	Full credit to offshore investor (no indemnification)	Full indemnification by resident (no credit)	Full indemnification by resident (full credit)	No IWT	No Credit to offshore investor (no indemnification)
Gross Interest Paid at 1 July 2014	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00
IWT Withheld on 1 July 2014	\$ 10.00	\$ 10.00	\$ 10.00	\$ -	\$ 10.00
Actual Payment Remitted at 1 July 2014	\$ 90.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 90.00
Tax Payable in Residence Country (assume 30% tax rate)	\$ 30.00	\$ 33.00	\$ 33.00	\$ 30.00	\$ 30.00
		(\$110 taxable income if indemnification considered income)			
Net Tax Payable	\$ 20.00	\$ 33.00	\$ 23.00	\$ 30.00	\$ 30.00
PV of net tax payable (assume 31 December 2014 financial year end) at 1 July 2014 with 3% discount rate	\$ 19.70	\$ 32.51	\$ 22.66	\$ 29.55	\$ 29.55
NPV at 1 July 2014	\$ 70.30	\$ 67.49	\$ 77.34	\$ 70.45	\$ 60.45

Furthermore, circumstances where the lender is indemnified by the borrower in relation to IWT are not totally equivalent to circumstances involving full credits. The best situation for an investor is where they are sufficiently powerful to require an indemnification clause *and* receive full credit. Failing this, in net present value terms, the next best option is no IWT. The situation of full credits is, based on this scenario, 0.21 per cent less profitable than no IWT. While this is a minuscule difference in

⁵⁷ Reuven Avi-Yonah, Nicola Sartori and Marian Omri, *Global Perspectives on Income Taxation Law* (2011).

⁵⁸ Khoo, above n 15; Eijffinger, Huizinga and Lemmen, above n 16.

⁵⁹ Jüttner and Carlsen, above n 12; Eijffinger, Huizinga, and Lemmen, above n 16.

⁶⁰ Khoo, above n 15; Herman, Doron, *Taxing Portfolio Income in Global Financial Markets* (2002).

⁶¹ Jüttner and Carlsen, above n 12.

absolute terms, to wholesale debt financiers this may be a significant margin.⁶² Conversely there will be a range of cases where a credit is not totally available and the net present value difference will be more substantial.⁶³ However, in reality the general distortion argument is about whether a potential investor decision to invest in Australia could be influenced by the presence of an IWT. While such a tax may influence a decision⁶⁴ the causative impact of an IWT alone not entirely clear. The decision to invest is arguably also based on a range of other more important factors,⁶⁵ and thus many investors may be *almost* indifferent to IWT when compared with other factors such as sovereign risk and currency values.

What of the recipient—will there be a distortion between foreign and non-foreign debt in the presence of an IWT? As shown by the scenarios below, because the recipient still has a deduction for the same gross interest amount, there is no net present value change provided the IWT withheld is actually remitted to the ATO. The only major distortion will be when there is an indemnification clause⁶⁶ because the borrower will be generally paying a higher gross interest amount (as noted above, such indemnification payments are generally deductible).

Table 2: Illustration of different withholding tax scenarios for borrower

	Foreign Debt - Indemnification	Foreign Debt - No Indemnification	Domestic Debt
Gross Interest Paid at 1 July 2014	\$ 110.00	\$ 100.00	\$ 100.00
IWT Witheld on 1 July 2014	\$ 10.00	\$ 10.00	\$ -
Tax Deduction	\$ 110.00	\$ 100.00	\$ 100.00
Maximum Value of Deduction (Assume 30% tax rate)	\$ 33.00	\$ 30.00	\$ 30.00
PV of deduction (assume 30 June 2015 financial year end) at 1 July 2014 with 3% discount rate	\$ 32.04	\$ 29.13	\$ 29.13

For both the borrower and the lender, this paper has considered a range of scenarios with different credit outcomes which is a reflection of what can result from the patchwork of treaty terms that apply throughout the world. The structure of the IWT provisions and treaty obligations mean that sourcing debt from some countries will give rise to no IWT⁶⁷ while sourcing debt through certain structures such as

⁶² Weishi, de Mooij and Poghosyan, above n 40; Keen and de Mooij, , above n 32.

⁶³ Khoo, above n 15; Jüttner and Carlsen, above n 12; Goulder, above n 56.

⁶⁴ Richard Bird, *The Taxation of International Income Flows : Issues and Approaches* (1987); Goulder, above n 56; Geremia Palomba, 'Capital Income Taxation and Economic Growth in Open Economies' (2004) *IMF Working Paper* 04/91; Leslies Papke, 'International Differences in Capital Taxation and Corporate Borrowing Behaviour : Evidence from the US Withholding Tax' (1989) *NBER Working Paper* no 3129.

⁶⁵ Khoo, above n 15; David Holland and Richard Vann, 'Income Tax Incentives for Investment' in Thuronyi, Victor (ed) *Tax Law Design and Drafting* (1998); S Matthews, 'What is a "Competitive" Tax System?' (2011) *OECD Taxation Working Papers* no 2; OECD, *Corporate Tax Incentives for Foreign Direct Investment* (2001).

⁶⁶ Jüttner and Carlsen, above n 12.

⁶⁷ Khoo, above n 15.

Eurobonds will similarly incur no IWT.⁶⁸ Likewise, tax exempt entities and government lenders such as sovereign wealth funds are entitled to exemptions from IWT.⁶⁹ Thus, due to IWTs, investors may have a preference to invest in certain countries over others,⁷⁰ and as noted by the Henry Review,⁷¹ give access to funds via different methods over others.⁷² The result is that in Australia, the supply of debt from certain countries and through certain methods, such as Eurobonds, may be larger while the supply of debt through retail deposits may be smaller than if there had been no IWT.⁷³ This potential skewing of the apparatus of inbound capital can have an impact on the stability of domestic markets and the ability to withstand economic shocks.⁷⁴

Once again though, this paper does not dispute that distortions due to IWT are possible but instead questions the significance of their impact on real world choices. Individual investors may be swayed by IWTs but there are also more significant factors, such as sovereign risk and currency values.⁷⁵ IWT is still collected in Australia meaning that although there is an option to invest capital in countries where there is no IWT, capital still flows to Australia. Consequently, despite a highly mobile capital base,⁷⁶ other factors pull capital perhaps in a stronger way than the presence of an IWT repels capital. Thus, the applicability of IWT on payments from Australia is perhaps not a determinative factor. Hence, in summary, IWTs may be distortionary but perhaps such distortions are not determinative or, in worst case, destructive. Distortions created by differentiated and patchwork IWTs are perhaps small when one considers the structural distortions created by debt and equity in general.⁷⁷ As a result, the decision to reduce IWTs cannot be justified by simply looking at distortions.

⁶⁸ Jüttner and Carlsen, above n 12.

⁶⁹ Jüttner and Carlsen, above n 12; Norrengaard, John. 'The Tax Treatment of Government Bonds' (1997) *IMF Working Paper* 97/25.

⁷⁰ Papke, above n 64.

⁷¹ Australia's Future Tax System Review, above n 37.

⁷² Ho Hudson, Frost and Pinson, above n 32; Norrengaard, above n 69; Papke, above n 64.

⁷³ Norrengaard, above n 69.

⁷⁴ OECD, 'International Capital Mobility: Which Structural Policies Reduce Financial Fragility?' (2012) *OECD Economic Policy Papers* no 2; Norrengaard, above n 69; Zee, Howell. 'Retarding Short Term Capital Inflows Through Withholding Tax' (2000) *IMF Working Paper* 00/40.

⁷⁵ Khoo, above n 15; Holland and Vann, above n 65; Eric Zolt, 'Taxation of Investment Funds' in Thuronyi, Victor (ed) *Tax Law Design and Drafting* (1998), 969 - 985; Matthews, above n 65; OECD, above n 65.

⁷⁶ Jüttner and Carlsen, above n 12;; OECD. 'International capital mobility: Which structural policies reduce financial fragility?' (2012) *OECD Economic Policy Papers* no 2; D Carey and H Tchilinguirian, 'Average Effective Tax Rates on Capital, Labour and Consumption' (2000) *OECD Economics Department Working Papers* no 258; George Zodrow, 'Capital Mobility and Capital Tax Competition' (2010) 63(4) *National Tax Journal* 865.

⁷⁷ Weishi, de Mooij, and Poghosyan, above n 40; ; Cooper, above n 40; Keen and de Mooij, , above n 32; de Mooij, Ruud. 'Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions' (2011) *IMF Working Paper* 11/11; R Gordon, 'Taxation and Corporate Use of Debt: Implications for Tax Policy' (2010) 63 *National Tax Journal* 151.

6. CERTAINTY, INVESTMENT AND COST OF CAPITAL

Another argument that is often used to support a reduction of IWTs is that such a course will increase investment.⁷⁸ That is, reducing IWTs will potentially not only reduce distortions, which are bad per se because they potentially result in less than optimum welfare,⁷⁹ but will also lead to increased investment and economic activity.⁸⁰ While reduced distortions can lead to increased investment as a matter of general principle,⁸¹ it is not only the distortionary effect of IWTs that impact on investment but the simplicity, certainty, stability and consistency of the tax as well;⁸² or in other words, the investment climate. After all, investors often crave certainty and it is more certain that there will not be an unforeseen IWT liability if there is no IWT than if there are a range of technical exemptions that may apply in Australia. So the removal of IWTs can be *partly* justified due to a likely increased investment level owing to greater certainty. The ultimate justification being that such increased investment will increase revenue intake.

However, it is difficult to fully justify such a course of action by citing increased investment alone.⁸³ This is because the forgone IWT is a tax on gross amounts whereby any additional tax from increased investment will be on net amounts, thus compensating for lost revenue is difficult. A simple illustration is as follows. Assuming that IWTs are removed from financial institutions in Australia then an estimated \$541 million of revenue would be forgone based on the 2011–12 figures detailed above.⁸⁴ The additional tax revenue from this removal would be a product of the amount of new investment capital and the margin that this new capital could generate for resident taxpayers.⁸⁵ Assuming interest costs are deductible to the resident and that tax is paid at the corporate rate, a number of simulations can be run as shown below. To ‘break even’ at \$541 million, there would need to be around \$100 billion of new investment at a margin of around 1.75 per cent or \$50 billion at a margin of around 3.5 per cent. As new investment reaches more practical levels, the margin required to ‘break even’ increases significantly (shown in graph below). Even if there is a large multiplier effect, it would seem to be impractical to recover the lost revenue from IWTs due to increased investment alone because this would entail an

⁷⁸ Khoo, above n 15; Avi-Yonah, Reuven. ‘Globalization, Tax Competition and the Fiscal Crisis of the Welfare State’ (2000) 113 *Harvard Law Review* 1573; Holland and Vann, above n 65; Neil Pereira, ‘Enhancing Investment in Australia—A Competitive Neutrality?’ (2011) 46(5) *Taxation in Australia* 186; OECD, *Possible Improvements to Procedures for Tax Relief for Cross Border Investors* (2009); Ault and Bradford, above n 4; Rachel Griffith, James Hines Peter and Sorensen, ‘International Capital Taxation’ in Mirrlees, J, Adam, S, Besley, T, Blundell, R, Bond, S, Chote, R, Gammie, M, Johnson, P, Myles G and Poterba J, (eds) *Dimensions of Tax Design: the Mirrlees Review* (2010).

⁷⁹ J Mirrlees, S Adam, T Besley, R Blundell, S Bond, R Chote, M Gammie, P Johnson, G Myles and J Poterba J (eds) *Dimensions of Tax by Design: The Mirrlees Review* (2010); Bernard Salanié, *The Economics of Taxation* (2011); Goulder, above n 56. However, withholding taxes may be used as a form of corrective tax to distort behaviour away from ‘bad’ investment. See Zee, above n 74; T Piketty and E Saez, ‘A Theory of Optimal Capital Taxation’ (2012) *NBER Working Paper* 17989.

⁸⁰ OECD, above n 78.

⁸¹ Palomba, above n 64.

⁸² Holland and Vann, above n 65.

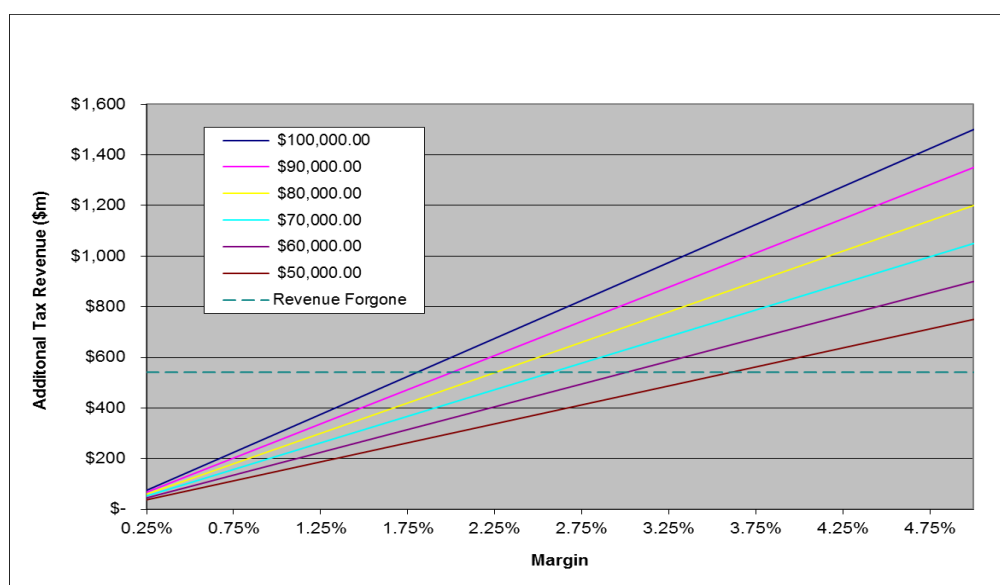
⁸³ Khoo, above n 15.

⁸⁴ \$541 (million) = 2.8680% effective tax rate x \$18,872 (million) interest debts.

⁸⁵ Additional Tax Revenue = (new capital x margin) x tax rate.

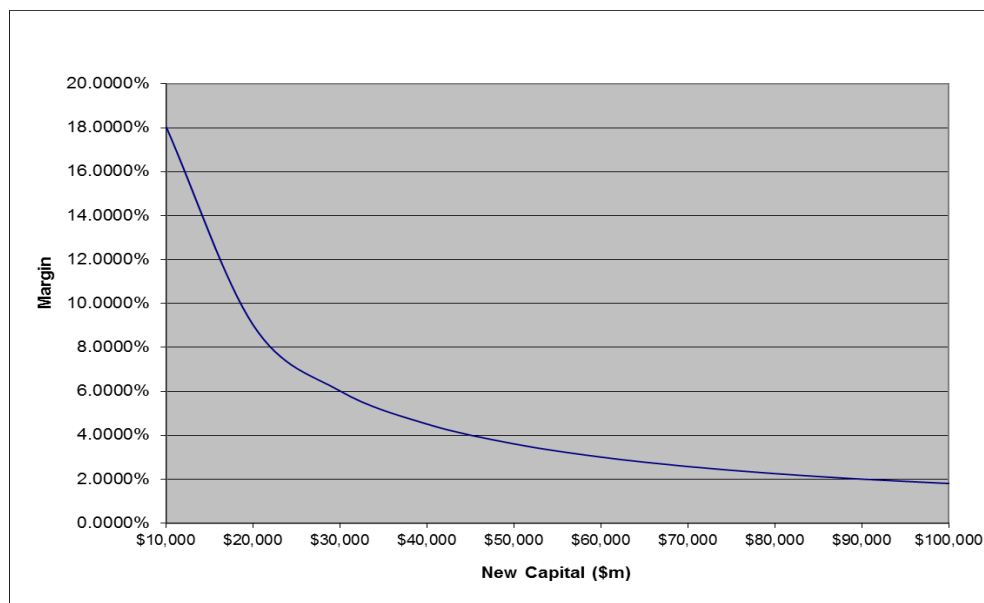
imponderable level of elasticity.⁸⁶ For instance, with these simulations, even if there is a best case scenario of an unrealistic margin of 18.0417 per cent, new capital investment of \$3.333 billion and a very high multiplier of 3 (giving total new activity of \$10 billion) there would be 'break even' but the elasticity inherent in such a situation would be over 6 (that is, \$6 of extra investment for each \$1 of tax saved).⁸⁷ To reiterate, though removal of IWTs in Australia would increase investment, it is difficult to see how the scale of extra investment alone would justify such a course of action.

Figure 5: Additional tax revenue for different new capital levels



⁸⁶ Ruud de Mooij, 'The Tax Elasticity of Corporate Debt: A Synthesis of Size and Variations' (2011) *IMF Working Paper* 11/95; For FDI see Ruud de Mooij and Sjef Ederveen, 'Taxation and Foreign Direct Investment—A Synthesis of Empirical Research' (2003) 10 *International Tax and Public Finance* 673.

⁸⁷ Such a level of elasticity would be outside current empirically determined levels - de Mooij, above n 86. For FDI, see de Mooij and Ederveen, above n 86.

Figure 6: Margin required at capital levels

A related rationale for the removal of IWTs is the effect that this could have on the cost of capital for Australian firms.⁸⁸ As the Henry Review pointed out,⁸⁹ the presence of an IWT in Australia influences the interest rate and ultimately the cost of capital paid when accessing foreign capital.⁹⁰ This may be direct, in the form of indemnity arrangement, or it may be more indirect through increased interest rates. The impact of a reduction to the cost of capital due to a removal of IWT will likely be that resident borrowers will have additional capital with which to spend throughout the economy.⁹¹ Therefore the ultimate effect on the revenue will be similar to that above, in the form of greater (net) tax on economic activity. Once again, even with the combined effect of additional investment and reduced cost of capital however it is still tough to envisage that there would be a dollar for dollar replacement of revenue forgone due to reduced IWTs. Thus, to justify a reduction of IWTs there must be ultimately something more than economics referred to; vis à vis - the reduction of IWTs also results in increased political capital and information. With IWTs the political capital and information aspects are, if anything, more important than the distortionary and investment aspects.

⁸⁸ McCann and Edgar, above n 16; Jüttner and Carlsen, above n 12; Dirks and Bondfield, above n 16; Eijffinger, Huizinga, and Lemmen, above n 16; Huizinga, above n 16; Auerbach, above n 16.

⁸⁹ Australia's Future Tax System Review. *Final Report* (2009).

⁹⁰ Jack Mintz, 'An Evaluation of the Business Tax Recommendations of the Henry Review and the Australian Government Response' in Chris Evans, Richard Krever, Richard and Peter Mellor (eds) *Australia's Future Tax System: The Prospects After Henry* (2010); McCann and Edgar, above n 16; Vann, above n 28; Eijffinger, Huizinga, and Lemmen, above n 16; Huizinga, above n 16; Auerbach, above n 16.

⁹¹ McCann and Edgar, above n 16.

7. POLITICAL CAPITAL AND INFORMATION

The bilateral negotiation of the reduction of IWTs through tax treaties represents the application of diplomacy rather than just simple economics.⁹² Reducing the levels of IWT in a country transfers revenue from the country of the borrower to the country of the lender.⁹³ In return for such a transfer, the country of the lender generally provides access to information in the possession of the country, which is a tangible and valuable outcome for revenue administration.⁹⁴ In some cases, a country will even agree to act in the interests of the other country on request.⁹⁵ This information and resultant action can, in many cases, be more valuable than the IWT revenue forgone as it may enable revenue authorities to identify and reduce tax avoidance which may therefore result in hundreds of millions of dollars of amended assessments.⁹⁶ Under these trade-offs, a country forgoes the ability to partly tax overt funds (interest payments) in return for the ability to fully tax undeclared funds. Apart from being pragmatic, such an approach can also be efficient because it is always more efficient to tax previously un-taxed funds.⁹⁷

The political capital created by forgoing IWT can also be used for any number of other tangible concessions from the treaty partner such as improved investment incentives or development loans.⁹⁸ Finally, while it is beyond the scope of this paper to fully discuss aspects of international diplomacy, the overwhelming trend worldwide, as endorsed by the OECD,⁹⁹ is for a reduction and removal of IWTs, and there is diplomatic credit to be gained by 'going with the crowd', so to speak. It is sometimes just as valuable to be *seen* to conform to the prevailing orthodoxy and therefore build a perception of productive diplomacy. So a reduction of IWTs is not just about investment capital but political capital. Furthermore these political and diplomatic

⁹² Vann, above n 28; Michael Dirkis, 'Looking Beyond Australia's Horizon : The Internationalisation of Australia's Domestic Taxation Information Gathering and Debt Collection Powers' in Michael Walpole and Chris Evans, Chris (eds) *Tax Administration : Safe Harbours and New Horizons* (2008), 79 - 97; Dale Pinto, 'The Theoretical Foundations and Continued Rationale for Source Based Taxation in an Electronic Commerce Environment' (2012) 27 *Australian Tax Forum* 443; Ault and Bradford, above n 4.

⁹³ Jüttner and Carlsen, above n 12; Khoo, above n 15; Avi-Yonah, Sartori and Omri, above n 57; OECD, above n 78; Ault and Bradford, above n 4; Zee, above n 4; Griffith, Hines and Sorensen, above n 78.

⁹⁴ Dirkis, above n 92; Domingo Vasco and Pablo Porporatto, 'Progress in Transparency and Exchange of Tax Information' (2013) 35 *Tax Administration Review* 75; Isaác Esteban, 'Effective Implementation of Exchange of Information and International Taxation Units' (2013) 35 *Tax Administration Review* 105; OECD, *Tax Co-Operation 2010 : Towards a Level Playing Field* (2010); Congressional Research Service, *Tax Havens : International Tax Avoidance and Evasion* (2013); Ronald Davies, 'Tax Treaties and Foreign Direct Investment: Potential versus Performance' (2004) 11 *International Tax and Public Finance* 775.

⁹⁵ Dirkis, above n 92; Vasco and Porporatto, above note 94; Esteban, above n 94; OECD, above n 94; Congressional Research Service, above n 94.

⁹⁶ OECD, above n 94; Vasco and Porporatto, , above n 94; Esteban, above n 94; M D'Ascenzo, 'Sustaining Good Practice Tax Administration' (2009) 38 *Australian Tax Review* 76; J Shaw, K Slemrod and J Whiting, 'Administration and Compliance' in J Mirrlees, S Adam, T Besley, R Blundell, S Bond, R Chote, M Gammie, P Johnson, G Myles and J Poterba (eds) *Dimensions of Tax Design: the Mirrlees Review* (2010), 1100–1203; International Tax Dialogue, 'Revenue Administration in Sub-Saharan Africa' (2010) *ITD Comparative Information Series* No 1.

⁹⁷ Richard Bird, 'Smart Tax Administration' (2010) 36 *Economic Practice* 57398; John Hasseldine, 'The Administration of Tax Systems' in E Albi and J Martinez-Vazquez (eds) *The Elgar Guide to Tax Systems* (2011), 360–375.

⁹⁸ Vann, above n 28; Vasco and Porporatto, above n 94; Esteban, above n 94.

⁹⁹ OECD, above n 14.

aspects are perhaps more important than the distortion and investment aspects outlined previously due to the lower scale of such aspects.

However, there are two provisos that are potentially moving the balance of political and diplomatic considerations in favour of not reducing IWTs. Firstly, the reduction of IWTs is only one in a number of concessions that can be proffered under diplomatic negotiations. Secondly, with the growing recognition of the problem of BEPS there has potentially been a reinvigoration of the consideration of IWTs. Under the OECD's 2013 *Base Erosion and Profit Shifting Action Plan* there is recognition of the issues of 'treaty shopping' and the use of hybrid instruments which are intertwined with IWT issues in the subject treaties.¹⁰⁰ While developing countries have often been noted as being at risk due to a reduction of IWTs,¹⁰¹ Australia's reduction of IWT in its treaties may well have contributed to an incentive to lend funds to Australia from a low tax jurisdiction rather than invest directly. The issue of BEPS involves multinational entities utilising this incentive to the utmost. As such, a further reduction of IWT may be seen as further facilitating such issues. However, with action on BEPS being very much a live issue, it is yet to be seen whether IWT reduction comes off the table in future treaty negotiations.

8. THE ADMINISTRATIVE ASPECTS OF REMOVAL

Finally, removing withholding taxes in general has been part of the orthodox understanding of the progression from early stage revenue authority, with limited information capacity, to a more adept and more efficient authority.¹⁰² Thus, there is an aspirational aspect to removal of IWTs from an administrative perspective. For a country like Australia, having significant withholding taxes could be seen as vestigial, though the position could be different in a less developed country which requires every cent of revenue it can get.¹⁰³ Once again, this is something of a *seen* to be done requirement. On the other hand, in terms of more tangible outcomes, the IWT in Australia raises little revenue but it can be seen as creating significant operating costs.¹⁰⁴ Unlike more broad based taxes, the operating costs of the IWT may actually be larger than the revenue gained (which is not significant). Furthermore, reducing the IWT would improve the level of complexity in relation to the tax system,¹⁰⁵ at least from the point of view of resident recipients and the ATO (rather than Australians

¹⁰⁰ IMF, *Spillovers in International Corporate Taxation* (2014).

¹⁰¹ IMF, above n 100; Peter Barnes, 'Limiting Interest Deductions' *UN Papers on Selected Topics in protecting the Tax Base of Developing Countries* (2014).

¹⁰² John Hasseldine, 'The Search for Best Practice in Tax Administration' in Michael Walpole and Chris Evans, (eds) *Tax Administration : Safe Harbours and New Horizons* (2008), 7- 18; OECD, *Tax Administration 2013* (2013).

¹⁰³ Bird and Gendren, above n 6; Bird, above n 97.

¹⁰⁴ Lee Burns and Richard Krever, 'Taxation of Income From Business and Investment' in Victor Thuronyi, (ed) *Tax Law Design and Drafting* (1998); Mirrlees, et al., above n 79; OECD, above n 78; Chris Evans, 'Studying the Studies: An Overview of Recent Research into Taxation Operating Costs' (2003) 1(1) *eJournal of Tax Research* 64.

¹⁰⁵ Burns and Krever, above n 104. Though a simple IWT, unlike the Australian IWT, with its many exemptions and the like, may actually make things simpler because of the 'once and for all' character; Mirrlees, et al., above n 79; Binh Tran-Nam and Stewart Karlinsky, 'Small Business Tax Law Complexity in Australia' in Michael Walpole and Chris Evans (eds) *Tax Administration : Safe Harbours and New Horizons* (2008), 321 - 348; OECD, above n 78.

providing debt overseas who would deal with other IWT regimes) and it has been established that simplification, to a point, is beneficial in and of itself.¹⁰⁶ Offsetting these administrative gains is the fact that removing or reducing IWTs does reduce the amount of information available to the ATO to data match against¹⁰⁷ however this may well be compensated by increased information from treaty partners. Therefore, reducing IWTs would normally be recommended from an administrative point of view. However, a number of comparable jurisdictions have begun instituting withholding taxes on interest as a means of final taxation, which provides an alternative direction in which to move.

9. FINAL WITHHOLDING TAXES INSTEAD

As of 2014, a number of OECD countries have instituted final withholding taxes on interest income. Austria, Belgium, the Czech Republic, Finland, France, Germany, Greece, Hungary, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Poland, Portugal, Slovak Republic, Slovenia and Turkey all have final withholding taxes on interest.¹⁰⁸ Such taxes are efficient in relation to the taxation of capital income (being flat rate taxes). Furthermore, a number of these taxes, such as the final withholding tax in Germany, are part of a final flat rate withholding tax on all investment income which was a measure recommended in the Henry Review as a means of fundamental tax reform. As well, such taxes provide a degree of administrative simplicity since the recipient does not need to report interest income on their tax returns nor does the revenue administration need to audit the reporting. Instead the revenue authority can deal with a smaller group of payers of interest. Therefore, IWTs need not be reduced; instead a worthwhile course may be to broaden their impact and merge such taxes with a general investment income withholding tax.

10. CONCLUSION

It has been argued in this paper that the current trend towards a reduction of IWTs cannot be justified by economic distortions and investment flows alone. Certainly, IWTs may impact on investment but it is far from clear whether IWTs can be a decisive causative factor rather than something that is costed into settled decisions. IWT reduction is more about international diplomacy and the search for political capital and access to offshore financial information. But of course, IWT would not be a valuable concession in such arenas unless it did have some impact on investment. The effect on corporate finance, from a removal of IWTs could be positive and so it could be recommended that the *Tax Reform Road Map* phase down of IWTs be continued forthwith. As to the recommendation that the reduction be partly targeted to financial institutions the position is more complex. Such a course would likely lead to the investment benefits as outlined above. The problem however is that, as already noted (by the Henry Review itself even), the patchwork nature of the IWT provisions contribute towards distortions. A targeted reduction for financial institutions alone

¹⁰⁶ Sandford, above n 6.

¹⁰⁷ Jüttner and Carlsen, above n 12; Zee, above n 4.

¹⁰⁸ Michelle Harding, 'Taxation of Dividend, Interest and Capital Gains Income' (2013) *OECD Taxation Working Papers* no 19.

will potentially complicate existing distortions however it is not possible to be sure whether the net effect on welfare would be positive or negative. With the minimal amount of revenue at stake, it is possible, and may be better to dispense with IWTs altogether in one swoop rather than incrementally amend them and create new classes of exempt entities.

Thus, potentially, the broad recommendation of the Henry Review for a reduction of IWTs are potentially justified with some caveats but with new developments it would be perfectly possible to justify an opposite course. There is, in effect, more to the situation than just the distortions discussed by the Henry Review—though it is worth noting that some of these further developments have only been apparent post-Henry Review. The minimal revenue from IWTs in Australia perhaps hides the fact that IWTs may play an important part in how Australia deals with BEPS (not least of which because their phase down is perhaps one of the factors in how Australia got to where it is with BEPS). More importantly however the experience in a number of OECD countries suggests that the opposite course is possible. Instead of reducing IWTs, they could be retained and even expanded as part of a final withholding tax on interest, or even as part of a broad investment tax that could deliver efficiency and simplicity.