



5 August 2011

General Manager
Personal & Retirement Income Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: interestdiscount@treasury.gov.au

Dear Sir/Madam

Improving Incentives for Saving - Tax Discount for Interest Income

The Australian Financial Markets Association (AFMA) represents participants in the Australian wholesale banking and financial markets. Our members include banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. They are the major providers of services to Australian businesses and retail investors who use the financial markets. We welcome the opportunity to comment on the Discussion Paper on the Tax Discount for Interest Income.

AFMA welcomed the Treasurer's announcement in the May 2010 Budget because the tax discount for interest income will provide a more consistent tax environment for savings and encourage investors to diversify their investments (eg through deposits and retail bonds). This is a first step towards more neutral tax outcomes for investment choices that will ultimately assist the allocation and effective use of capital within the economy. In addition, as has been well documented elsewhere, Australia faces a shortage of high quality liquid assets to implement the Basel III liquidity framework, so the potential to expand the retail deposit base through these measures would assist banks to meet the more stringent liquidity requirements in a cost-effective way for the economy.

The Discussion Paper is a necessary and valuable step in the process to design measures to implement the policy to improve incentives for saving. We have two main comments in relation to the measures offered for consideration. Our first set of comments addresses the broad nature of the proposed reform measures, while the second deals with more technical aspects in the detail of the proposals.

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1. Net Interest Concept

The policy to provide a tax discount for interest income is intended to benefit Australian households. To be fully effective, the tax discount incentive should be capable of being readily understood and applied by individuals and should involve low taxpayer compliance costs. Thus, the design of the measures to implement the policy should be as simple and practical as possible.

It is proposed to apply the tax discount on net interest income received by individuals. This involves reducing the amount of eligible interest income received by the amount of expenses incurred related to that income, before exempting from tax 50 per cent of this net amount. While it may be argued that the net interest approach provides greater conceptual purity, it introduces significant complexity into the policy detail and higher tax compliance costs relative to the granting of the tax discount on a gross basis.

For example, the law will have to define the meaning of both the eligible interest income and the allowable expenses that relate to that income which taxpayers must then consider in preparing their tax returns and apply to their particular circumstances, which may involve a number of investment assets and liabilities. This means individuals will need to investigate and determine which of their expenses, if any, are allowable for the purpose of the discount and offset this against amounts they assess as being eligible interest income. This would not be a trivial exercise in many cases, since individuals are often not sophisticated taxpayers. Indeed, the examples presented in the Discussion Paper to explain the application of the measures illustrate the nature of the complexities that would be created for many individual taxpayers.

On balance, we believe the scale of the benefit being offered through the discount, the primary beneficiaries of the policy (being predominantly households, many with modest levels of financial and tax literacy) and the desire to minimise taxpayer compliance costs support the use of a gross interest concept to implement the Government's announced policy. This approach would reduce both the effort required of taxpayers and the risk placed on them to comply with the law and the outcome would remain consistent with the Government's policy objectives.

2. Policy Application to Geared Investments & Foreign Source Income

The Discussion Paper proposes that if net interest income is negative (that is, a taxpayer's interest-related expenses exceeds their interest income), the tax discount would still apply, which would mean that the taxpayer would only be able to deduct 50 per cent of their net interest loss against other income.¹

If this is meant to be read literally, it could result in the intended savings incentive becoming an actual tax penalty for some investors. For example, an investor whose interest income from an investment falls below the costs associated with the interest

¹ See footnote 9 in the Discussion Paper.

component of the investment would only be able to deduct 50 percent of the net interest loss against other income whereas the expenses would ordinarily be fully deductible in the absence of the savings interest 'incentive'.

In effect, there would be an asymmetry between tax treatment of interest income and the associated expenses under the proposed arrangements, as the benefit on the income side would be capped while there would be no cap on the amount on interest expenses that would be subject to the discount. Thus, contrary to the statement in paragraph 31 of the Discussion Paper, the tax discount would not apply equally to interest income and expenses.

Moreover, given that the stated purpose of the new measures is to "reduce the tax disadvantages that interest income has relative to other forms of savings income"², the proposed design as it applies to net interest losses appears inconsistent with this objective. It also appears contrary to the Government's broader position in relation to negative gearing deductions, in respect of which it has stated that it will not at any stage apply a discount to these deductions.³

The Discussion Paper notes that the likelihood of such a scenario is considered to be extremely rare. In practice, given the widespread use of geared investment products (like margin loans) and their application to portfolio investment products, this outcome is likely to be more common than expected.

The adverse policy outcome encountered in this situation provides a further reason to adopt a gross interest concept for the purpose of implementing the Government's policy. Certainly, at a minimum, investors should be given the option to either accept the savings incentive for interest income or to apply the ordinary law in the event that the incentive would deliver a negative tax outcome for them.

In a similar vein, we think that consideration should be given to limiting the scope of the policy to Australian sourced interest income. This approach would provide for easier implementation of the policy and would better target the broader policy objectives to support the Australian banks' deposit base and develop the retail bond market. Moreover, where an investor earns interest from both domestic and foreign sources, there would not be a consequent reduction in the benefit of foreign tax offsets in relation to tax paid on interest earned overseas (otherwise this would partly offset the discount benefit). This approach would ensure the full benefit of the policy, which is limited by a cap, accrues to individual investors in respect of their domestic debt investments.

Finally, we note that this approach would materially simplify the application of the policy for many individual taxpayers (consistent with our first point above concerning the net interest concept).

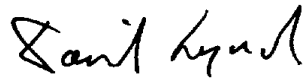
² See paragraph 6 of the Discussion Paper.

³ Federal Government Media Release No.028/2010 "*Stronger, Fairer, Simpler: A Tax Plan for our Future*" issued in response to the *Australia's Future Tax System Review* (Henry Review) Report 2010.

Concluding Comments

Thank you for accepting our comments on the proposals in the Discussion Paper. The tax discount for interest income is evidently a good policy initiative, which we are keen to see implemented to greatest effect. We are happy to further support your work in this area, if the opportunity for us to do so arises.

Yours sincerely

A handwritten signature in black ink, appearing to read "David Lynch". The signature is written in a cursive, slightly slanted style.

David Lynch
Head of Policy & Markets