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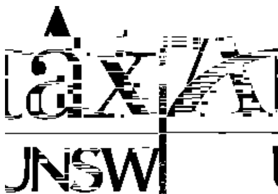

to IWTs is Division 11A of the *Income Tax Assessment Act 1936* (Cth) (ITAA 36) which requires that IWT be imposed on any interest derived by a non-resident when that interest payment is made by an Australian resident.[7] The rule is extended to include payments from non-residents where such payments 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]
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 cent[10] of the gross interest amount[11] 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]

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

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[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]
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,
(1998) 1(3) *Journal of Australian Taxation* 90 91 367.73 Tm [(P2] 19; Zee, above n 14 dugic E39 275.0oustr arisem

[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
Australian Tax Forum 597.

[16] Khoo, above n 15;(Cth), sYBãGAŠò29'PÃnCmy$i)ž62Ž3$@Y12)sLWKJ,QWHUQDWLRQDO,QFRQJ7DWLRW1u@WP

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 IWT[21] which mean amounts which are clearly interest are not subject to IWT. For instance, IWT is not imposed on

their cost of capital and reducing domestic investment [43] Furthermore the exemptions built into
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 been 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[2] 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] , above n 37 at 180.

[44] Aus , above n 37.

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

[46] Ibid.

[47] , 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

during the same period has increased at a far greater

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]

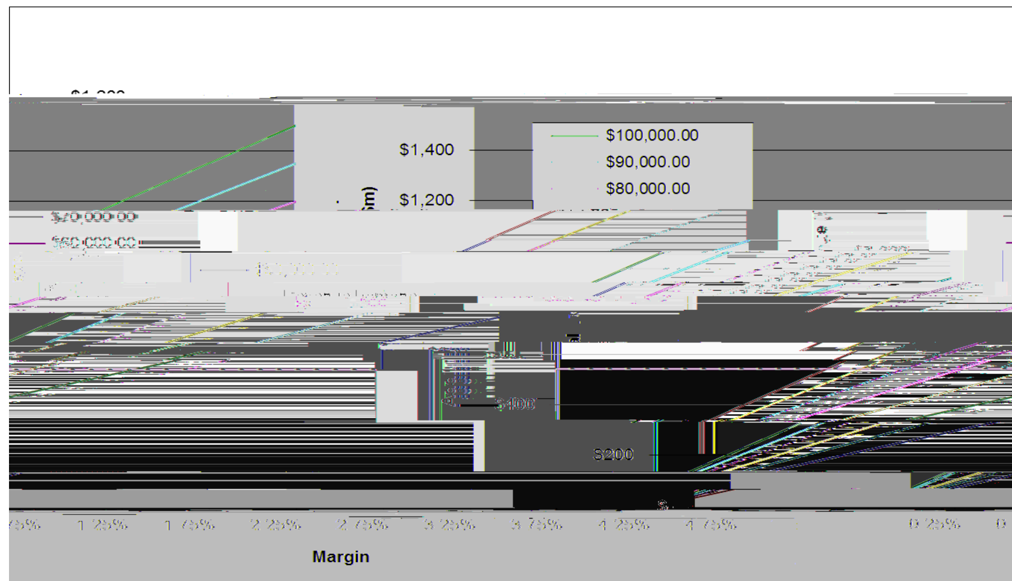
Once again though, this paper does not dispute that distortions due to IWT are possible but instead questions the significance of their impact on real world choices. Individual investors may be swayed by IWTs but there are also more significant factors, such as sovereign risk and currency values.[75] IWT is still collected in Australia meaning that although there is an option to invest ca/2(t)-40 ags

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

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 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.

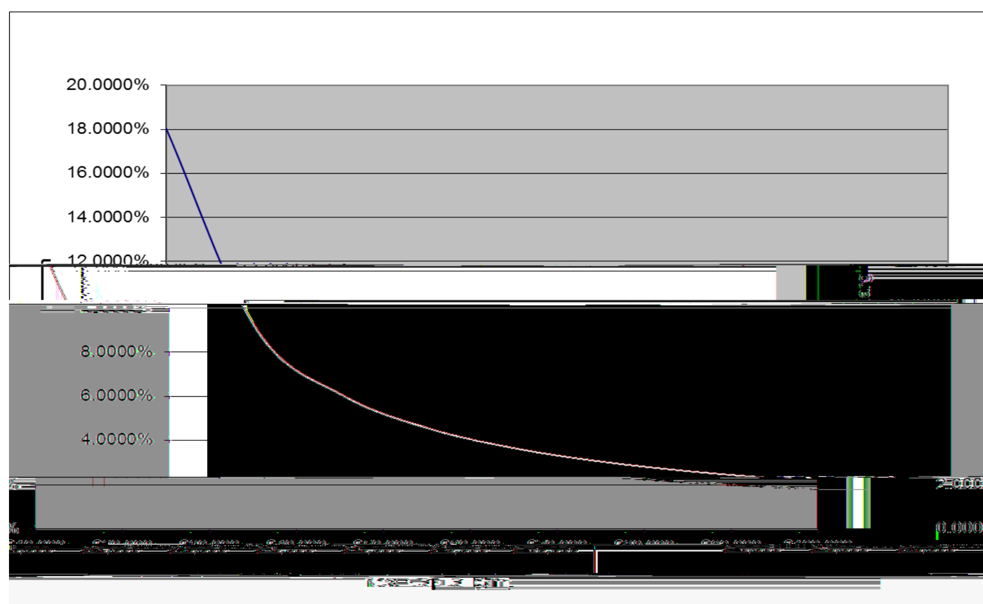
Figure 5: Additional tax revenue for different new capital levels



[86] Ruud de Mooij, 2011) *IMF Working Paper* 11/95; For FDI see Ruud de Mooij and Sjef Ederveen, Investment *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.

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

[89] *Final Report* (2009).

[90] Jack 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 reduc

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

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 against[107] 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 M6of*

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