REVIEW OF INTERNATIONAL TAXATION ARRANGEMENTS

Submissions by Export Finance and Insurance Corporation ("EFIC") to the Board of Taxation

1. Background

1.1 EFIC, Australia's export credit agency, is a body corporate established under the Export Finance and Insurance Corporation Act 1991 (Cth) ("EFIC Act").

1.2 Under paragraph 7(1)(a) of the EFIC Act one of EFIC's functions is "to facilitate and encourage Australian export trade by providing insurance and financial services and products to persons involved directly or indirectly in such trade".

1.3 The Attachment to this Submission contains a more detailed summary of EFIC's status, functions and activities.

1.4 Two of the main methods by which EFIC performs its functions are:

1.4.1 a loan by EFIC to an overseas borrower ("Loan") to assist the borrower to purchase Australian exports; and

1.4.2 an export guarantee facility by EFIC to a commercial bank ("EFG") which makes a loan to an overseas borrower to assist the borrower to purchase Australian exports.

2. Interest Withholding Tax

2.1 Interest Withholding Tax (IWT) is a tax levied upon interest payments made by a borrower in one country to a lender in another.

2.2 Although payment of the tax is made by the borrower, it is effectively a tax on the lender, as it reduces the amount of interest actually received by the lender. The lender will commonly, if permitted by the law of the relevant foreign country, seek to maintain its level of interest income by requiring the borrower to "gross up" interest payments for any IWT deducted, so that the lender receives the full amount of interest. Therefore, rather than being an additional cost of business for the lender, IWT becomes an additional cost that the borrower incurs when it utilises credit from foreign financiers, consequently impacting on the competitiveness of those financiers.

2.3 Some form of IWT is levied in most markets but, critically, in many key and emerging Australian export markets in Asia. Typically, tax is levied at 10% of the interest amount but may be higher.

3. The Review of International Taxation Arrangements

3.1 On 2 May 2002 the Treasurer announced a review of international tax arrangements to which Australia is a party. One area of particular attention was stated to be whether current arrangements hinder Australian companies from expanding offshore.

3.2 On 22 August 2002 the Treasurer released the consultation paper Review of International Taxation Arrangements prepared by the Department of the Treasury ("the Consultation Paper").

3.3 The Treasurer has asked the Board of Taxation to "consult extensively on the paper, consider the views put forward, and provide its recommendations to the Government together with a report on the outcome of the consultations….. by 31 December 2002" (Board Press Release No 10 of 22 August 2002).

3.4 The Consultation Paper states that:

3.4.1 "Tax treaties (or double tax agreements) govern the division of resident and source taxing rights between two countries……..However, the higher levels of withholding tax may disadvantage Australian companies operating offshore against local competitors and competitors resident in countries that negotiate lower rates" (at page 37);

3.4.2 "The Review of Business Taxation emphasised renegotiating treaties with our major trading and investment partners (particularly the United States) to reduce dividend withholding tax rates" (at page 38); and

3.4.3 "Australia currently is negotiating or renegotiating tax treaties with several countries" (at page 40).

4. Some deficiencies or risks in current tax treaty arrangements

4.1 Where EFIC makes a Loan to an overseas borrower, loan interest may be subject to withholding tax in that other country if Australia does not have a tax treaty with that country containing an appropriate exemption in respect of IWT. This may place EFIC at a disadvantage to overseas financiers or export credit agencies of other countries, hindering the performance of EFIC's functions to the detriment of Australian exporters, given EFIC's experience that many of its overseas counterparts do have exemption or relief from IWT for at least some of the financial services they provide. Because of the role EFIC plays in encouraging Australian export trade, there are strong competitive imperatives for Australia to negotiate clear, practical double tax treaty arrangements with as many of its trading partners as possible.

4.2 An anomaly may arise where a tax treaty between Australia and another country reduces or removes IWT from interest payable directly to EFIC under a Loan but not from interest payable to a lender to whom EFIC has guaranteed repayment of a loan under an EFG. An example is provided by sub-Article 11(3) of the "Convention between Australia and the Republic of Italy for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, and Protocol" (Canberra, 14 December 1982), under which:

> "interest derived by the Government of one of the Contracting States or by a political or administrative sub-division or a local authority thereof or by any other body exercising public functions in, or in a part of, a Contracting State, or a by a bank performing central banking functions in a Contracting State, shall be exempt from tax in the other Contracting State".

The way sub-Article 11(3) is worded the IWT exemption would be available to EFIC – being (we would say) a "body exercising public functions" - if EFIC derived interest from a Loan it had made to an Italian borrower but would not be available to a private bank to whom EFIC had given a 100% guarantee under an EFG, even if the guaranteed loan had been made to the same borrower, on identical terms and for the same purposes.

4.3 Another potential concern is the occasional lack of precision in the way in which entities intended to obtain the benefit of an IWT exemption under a Treaty are described. For example, the Treaty with Italy mentioned above refers to "a political or administrative sub-division" of a Government of a Contracting State and to a "body exercising public functions". At least one Treaty we have seen refers to a "monetary institution of the Government" (Double Tax Treaty with Indonesia). Such expressions are open to interpretation and therefore doubt as to their scope.

4.4 In other cases the lack of precision in a treaty may relate to the nature of the transaction giving rise to the interest payment in respect of which tax would otherwise be withheld. For example, Australia's double tax treaty with Thailand provides for a tax exemption in respect of interest derived from the "investment" of certain official reserves. It is not clear whether "investment" includes direct lending or is limited to passive investment, such as through acquiring bonds or debentures.

4.5 Some generality in the text of a Treaty is, of course, both inevitable and desirable. It is not realistic to expect absolute specificity in the language of an agreement between two or more countries. However, the potential vagueness of expressions such as "investment", "public functions" and "monetary institution" may give rise to doubts about a Treaty's coverage and may have unintended limiting effects. More broadly, such difficulties may be exacerbated by inconsistencies in the terminology used in different Treaties to describe the same or similar concepts.

5. EFIC's Submissions

5.1 **We submit** that Australia should seek to expand and enhance the tax treaties to which it is a party in order to:

5.1.1 remove withholding tax levied by foreign countries on interest payable to EFIC under a Loan and interest payable to other Australian lenders under a loan which is guaranteed by EFIC through an EFG;

5.1.2 bring about, as far as possible, consistency in the terminology of treaties used to describe the same or similar concepts; and

5.1.3 bring about treaties which are as certain and specific as possible in their description of the entities and transactions to which they apply, such as by supplementing general definitions with non-exhaustive lists of those persons or activities deemed to fall within a general description.

6. Summary

6.1 **We submit** that substantial benefits would be realised by removing the inequities and inconsistencies currently inherent in Double Tax Treaties.

6.2 We would be pleased to organise a telephone conference, or meet with you in person, to discuss our Submission further. Please do not hesitate to contact the undersigned should you require any clarification, or wish to arrange a meeting. We trust you will give due consideration to this Submission.

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ATTACHMENT

EXPORT FINANCE AND INSURANCE CORPORATION

Formation and Status

The Export Finance and Insurance Corporation ("EFIC") is Australia's official export credit agency. EFIC is presently established as a statutory corporation of the Commonwealth of Australia under the *Export Finance and Insurance Corporation Act 1991* (the "EFIC Act"). EFIC has existed under predecessor statutes since 1956.

EFIC's Functions

The functions of EFIC include:

- to facilitate and encourage Australian export trade by providing insurance and financial services and products to persons involved directly or indirectly in such trade;
- to encourage banks, and other financial institutions, carrying on business in Australia to finance, or assist in financing, export contracts or eligible export transactions;
- to provide information and advice to any person regarding insurance or financial arrangements available to support Australian export trade; and
- to do any other act or thing required by or under the EFIC Act or any other Act to be done by EFIC.

EFIC is required to perform its functions in such a manner as will best assist the development of Australian export trade.

EFIC is self-funding. It sets its premiums and charges, and manages its reserves, so that it can itself pay for the cost of its operations from its income stream.

For the most part, EFIC's facilities have been designed to complement the range of services offered by other institutions, such as banks and insurance companies, which assist the exporting community.

EFIC's Services

The business conducted by EFIC under the EFIC Act involves a range of services and facilities that have developed over a period of more than thirty years since Australia's official export credit agency was established. The range comprises the following services:

Export Credit Insurance

EFIC provides export credit insurance to Australian exporters against certain risks of exporting on deferred payment terms (usually short-term i.e. 360 days or less), enabling Australian exporters to provide credit to their buyers without exposing themselves to undue risk of loss.

Export Finance

EFIC lends, in various internationally traded currencies, to overseas purchasers of Australian capital goods and services. Such loans are made at subsidised rates of interest, where necessary, stemming from the fact that EFIC borrows funds at commercial rates to fund loans (and guarantees) at fixed interest rates determined under an arrangement with the OECD. Where the loans carry a subsidised rate of interest the Commonwealth, through an annual budgetary allocation, subsidises the difference between EFIC's commercial cost of borrowing and the subsidised rate at which it on-lends.

Export Finance Guarantee (EFG)

The EFG is a guarantee programme with terms usually ranging from 2 to 10 years. It allows a bank to replicate the features of an EFIC direct loan to an overseas buyer (at subsidised rates of interest, where necessary). The EFIC guarantee is used by the bank as security for commercial and/or political risk.

Political Risk Insurance

EFIC provides insurance to Australian overseas investors (usually for a term of 5 to 15 years) against the loss arising from inability to transfer earnings or the original investment to Australia, expropriation of the foreign enterprise and damage to or destruction of the foreign enterprise’s property by a war-like action.

Bonding Facilities

EFIC provides guarantees for financial institutions or insurers which provide performance bonds to overseas buyers on behalf of Australian suppliers. It also issues performance bonds in support of Australian export contracts and insures Australian suppliers of goods and services against the unfair calling of such bonds or guarantees.

National Interest Facilities

In addition to the business written on its own account, EFIC may also receive approval from, or be directed by, the Minister for Trade to underwrite business under the National Interest provisions of Part 5 of the EFIC Act.

EFIC, while supported by a Government guarantee under section 62 of the EFIC Act, operates on a commercial basis. EFIC may refer business to the Minister for Trade that is otherwise eligible for its support but which it is unable to undertake, either because of portfolio imbalance, or because the degree of risk involved could prejudice the maintenance of EFIC's self-funding status over time. Alternatively, the Minister for Trade may (other than through a referral by EFIC) become aware of business which he believes would be within EFIC's power to undertake, but may not satisfy EFIC's usual underwriting criteria.

Where the Minister for Trade believes the prospective business to be in the National Interest, he may approve or direct entry by EFIC into the transaction and take the risk on the Government's Account. EFIC would then enter into and administer the business under the National Interest provisions in Part 5 of the EFIC Act. In some cases, EFIC may decide to share some of the risk with Government.

For National Interest transactions, EFIC receives an administration fee from the Government. Risk related income is paid to the Government and any losses are to be borne by the Government to the extent that the Government is carrying the risk of the transaction.

EFIC's Capital Markets Powers

Funds for loans made by EFIC are borrowed from the domestic and international capital markets. EFIC services these borrowings and repays them from interest and principal instalments received under the export finance loans.