Media Release

Capital Protected Product Taxation – Time for Action

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The Australian Financial Markets Association (AFMA) today called on the Federal Government to act quickly to reinstate a clear and sensible set of rules for the taxation of products that offer a combination of gearing and capital protection that is sought by many investors, for example instalment warrants and protected equity loans.

In the May 2008 Budget the Federal Government announced a dramatic reduction in the tax deductibility of interest paid on capital protected borrowing by changing the benchmark interest rate from the variable rate for personal unsecured loans (currently 13.50%) to the Reserve Bank's indicator variable rate for standard housing loans (currently 5.75%).

The Government yesterday released its updated forward tax work program for announced tax measures, which states that consultation on draft legislation for capital protected borrowing is anticipated in the second half of 2009.

AFMA believes, given the costs imposed on investors and industry, the Government should accelerate action to return the market to a more normal economic footing. The benchmark rate prior to the 2008 Budget announcement was determined following an exhaustive 4-year consultation process involving numerous submissions from interested parties including detailed economic analysis.

The 2008 Budget announcement has not been legislated because the Government received information from the industry demonstrating that the new benchmark rate fails to recognise the real economic costs of protected equity loans and introduces a harmful tax distortion.

For instance, the interest paid on either a margin or personal loan used to acquire shares is fully tax deductible within the normal tax rules, even though margin and personal loan rates exceed the current benchmark rate. In contrast, tax deductibility of interest on a protected equity loan is restricted to a low uneconomic level, even though the capital protection shields investors from margin calls and lenders carry significant credit risk. This anomaly is strange at a time when investors are looking for capital protection in a more volatile market.

Ordinary investors are disadvantaged by the 2008 Budget benchmark rate because:

- it introduces a tax bias against capital protection on geared investments, which is most needed by investors in volatile markets;
- After tax returns to investors on capital protected products are reduced; for example, by up to 3.6% per annum on a capital protected growth portfolio; and
- investors who have been deterred by high tax cost of capital protection have suffered most, given the fall in share prices since May 2008.

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Investors also have a greater tax compliance burden because of the change:

- a broad range of investment and loan products that offer small amounts of capital protection are now within scope of the tax rules restricting interest deductibility;
- regular investors in capital protected products have to calculate several benchmark interest rates and make separate tax calculations to meet their tax obligations; and
- tax self-assessment for active investors is a more complex task.

The industry has been adversely affected by a significant reduction in product sales and business activity consequent to the announcement of the new benchmark interest rate and this has caused some job losses. Furthermore, the industry does not expect the measure to generate the forecasted tax revenue because of the fall off in activity relative to what would have occurred under the previous rate setting.

As we approach the end of June, this will be the fifth financial year-end out of the last six when there is significant doubt about the long term tax rules for capital protected products and their fairness for investors. This is an unsatisfactory situation for legitimate products that have served investors well over many years and should be addressed without further delay.

Technical Note:

Division 247 of the Income Tax Assessment Act 1997 splits a capital protected borrowing into two artificial components:

- an underlying loan - interest expense on this is deductible for tax purposes;
- capital protection - that is a capital item and is not deductible for tax purposes.

This is put into practice by imposing a limit on the amount of interest that is deductible on a capital protected borrowing by reference to a benchmark interest rate. For example, if the interest rate charged on a $100 protected equity loan is 15% and the reference benchmark interest rate is 8%; then $8 of interest expense is deductible for tax purposes and the remaining $7 is not because it is deemed to be a payment for capital protection.

Notes for Editors:

Australian Financial Markets Association (AFMA):

The Australian Financial Markets Association is the peak industry association for Australia's wholesale banking and financial markets. These markets play a pivotal role in the Australian economy by making it possible for Australian financial institutions and companies to conduct business with each other and with their counterparts overseas.

AFMA represents industry participants in the wholesale banking and financial markets, including Australian and foreign banks, securities companies, state government treasury corporations, fund managers, traders in electricity and other specialised markets and industry service providers.

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