6 February 2015

Mr Claudio Damiani
Budget Policy Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Via Email prebudgetsubs@treasury.gov.au

Dear Mr Damiani,

2015-16 Pre-Budget Submission

The Australian Financial Markets Association (AFMA) represents the interests of over 130 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

Consistent with the approach adopted in AFMA's 2014-15 Pre-Budget Submission, we acknowledge that the framing of the 2015-16 Budget will occur in the midst of consultation on the Final Report of the Financial System Inquiry and also the White Paper processes in respect of Taxation and Reform of the Federation. Accordingly, our Pre-Budget submission does not address issues within the terms of reference for these separate processes apart from those which, in AFMA's view, need to be addressed as a matter of urgency.

AFMA is also mindful of the continued fiscal challenges presented by the current global economic climate and the stated policy objectives announced by the Government with respect to returning the Budget to surplus in a foreseeable timeframe. Accordingly, the issues raised in our submission are those that AFMA believes will stimulate economic activity of Australian enterprises and hence be revenue accretive over the short to medium term.

As became apparent through the Financial System Inquiry, financial markets and particularly debt securities markets (such as corporate bond markets) are becoming systemically more important. Banks will be increasingly constrained in their capacity to leverage their balance sheets to comply with enhanced regulatory capital and liquidity

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requirements. Accordingly, it is our view that Government policy generally, and the 2015-16 Budget specifically, should reflect the current economic and financial climate and ensure that reforms that are undertaken promote the efficiency and competitiveness of the Australian financial markets. In particular, this means regulatory and other changes mandated through the G-20 or otherwise should be approached from a holistic perspective, adopting a "whole of regulation" mantra. That is, to the extent that changes are required to the taxation system to ensure consistency with regulatory reforms, these be implemented consistently and not only where there is a perception that the amendments will be revenue accretive for the Government. The request for a specific interest withholding tax exemption for interest paid to or from Central Counterparties, as set out in more detail below, is an example of where the Government should adopt a holistic approach to the consequences of regulatory intervention.

In a similar vein, AFMA also urges the Government to consider policy settings and impacts of reform beyond the forward estimates period. We continue to advocate measures that will, in time, promote banking competition, ensure the ongoing viability of, and indeed improve, our financial services industry and increase the efficiency of capital moving in and out of Australia. While the implications of such measures may not be revenue accretive (or indeed may be unquantifiable) over the forward estimates period, in AFMA's view they will deliver real benefits over a reasonable time-frame and are crucial to ensure that the financial system has the necessary grounding to continue to service the real economy in an optimal manner. To that end, we recommend that the Government implement appropriate changes to the costing model adopted by Treasury to allow consideration of both second order consequences and also consequences that may arise beyond the forward estimates period.

The structure of our submission is that we have detailed matters of urgency in the body of the submission. For completeness, we have set out in Appendices matters that have been previously raised in AFMA's Pre-Budget submissions but are yet to be resolved satisfactorily.

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Thank you for the opportunity to contribute to the Government's consideration of matters that should be addressed in the 2015-16 Budget. We would be happy to discuss any of the matters that we have raised in this submission.

Yours sincerely,

Rob Colquhoun
Director, Policy

1. Regulator Funding – Moratorium and Adherence to Cost Recovery Guidelines

One of the more concerning announcements from the 2014-15 Federal Budget was the replacement of the cost recovery arrangements, as they applied to the Australian Transaction Reports and Analysis Centre (AUSTRAC), with a new industry contribution model. Under the model, the proportion of AUSTRAC's total expenses recovered from industry will increase from 53% (the cost of AUSTRAC's regulatory arm) in 2013-14 to 100% by 2017-18. Essentially, the model sees the Government recover the costs of AUSTRAC's Financial Intelligence Unit - the primary beneficiaries of which are Government border protection, enforcement and revenue agencies - from industry.

AFMA was particularly concerned that the Government abandoned its own cost recovery guidelines by making this announcement. As noted by in its document "AUSTRAC industry contribution - outcome and feedback of stakeholder consultations:"

> "The new charge on industry as announced in the 2014-15 Budget is not subject to the Government's cost recovery guidelines or the requirements for a regulatory impact statement because it is neither a cost recovery or a regulatory arrangement."

AFMA does not understand the rationale for implementing a model which is clearly one of cost recovery but is not subject to its own cost recovery guidelines, merely through re-badging the model as one of "industry contribution." The practical impact on industry is that substantial amounts of money are required to be paid by regulated entities every year, but without the rigour, transparency or governance of the process that applies under the cost recovery guidelines.

Accordingly, we request that, in the 2015-16 Budget, the Government ensures that the industry contribution arrangements (such as those that apply to AUSTRAC) are made subject to the Government's own cost recovery guidelines and that, as a consequence, the costs of AUSTRAC's Financial Intelligence Unit are outside the industry contribution arrangements.

More generally, we note that the Final Report of the Financial System Inquiry has proposed that the Government should consider an industry funding model with respect to ASIC. It is AFMA's expectation that this recommendation will be the subject of considerable debate and consultation, both in terms of whether an industry funding model for ASIC is appropriate and, if so, the structure of such a model. In light of this, we believe it is appropriate for the Government to impose a moratorium on any increases in current industry funding arrangements, such as the ASIC market supervision levy, until the FSI recommendation is fully considered and the issues related to regulator funding are resolved.

2. Discontinuance of Phase-Down of Interest Withholding Tax

AFMA continues to strenuously object to the decision made by the Government to discontinue the previously announced phase-down of interest withholding tax (**IWT**) for financial institutions. This announcement was formally made by the Government as part of the repeal of the Minerals Resource Rent Tax.

AFMA's 2014-15 Pre-Budget submission sets out the basis for our objection in detail. The matters detailed in this submission remain current.

In addition, we note the comments made in the Final Report of the Financial System Inquiry, which made the following observations:

> "(w)ithholding taxes generally increase the required rate of return for foreign investors, which reduces the relative attractiveness of Australia as an investment destination. Where foreign investors can pass on the cost to domestic recipients, this raises the cost of capital in Australia…reducing IWT would reduce funding distortions, provide a more diversified funding base and, more broadly, reduce impediments to cross-border capital flows."

In essence, the Financial System Inquiry Panel agrees with previous observations made in the Johnson Report and the Henry Tax Review that, as a nation that relies on the importation of capital to ensure continued growth, it is incongruous that the Government persists with a measure that significantly hinders the free movement of capital into Australia and ultimately causes Australian businesses to pay a higher rate for debt finance, ultimately rendering such businesses less competitive relative to their global peers.

AFMA urges the Government, to acknowledge the observations of the Financial System Inquiry and the recommendations of the Johnson Report and Henry Tax Review and commit to the phase-down of interest withholding tax, as previously announced, in the 2015-16 Budget.

3. Release of Board of Taxation Reports

At the time of writing, there are three Board of Taxation reports relevant to the AFMA membership that have been delivered to Government but not released publicly. These are:

- Tax Arrangements Applying to Permanent Establishments (delivered April 2013);
- Review of the Tax Arrangements Applying to Collective Investment Vehicles (delivered December 2011); and
- Taxation Treatment of Islamic Finance Products (delivered June 2011).

These reports summarised the detailed work undertaken by the Board of Taxation and ought to be influential in shaping the Government's policy response in these areas. Accordingly our view is that they should released publicly. While ideally the Government would simultaneously release its response to the reports, as is standard practice, it would be preferable for the reports to be released without a Government response than not at all.

AFMA has a particular interest in the report into the Tax Arrangements Applying to Permanent Establishments, as this report will set out the Board's view as to the advantages and disadvantages associated with the adoption of the functionally separate entity approach in the determination of profits attributable to a permanent establishment, both under Australia's domestic law and also in the network of Double

Tax Treaties. This is an area of taxation law and administration that requires urgent clarity from a policy perspective.

4. Abolition of the LIBOR Cap

The Board of Taxation Report into the Tax Arrangements Applying to Permanent Establishments will also set out the Board's view on the continued appropriateness of the "LIBOR Cap," which is a statutory provision that operates to deny deductibility of interest for an Australian branch of a foreign bank above the applicable LIBOR.

AFMA maintains that the LIBOR Cap unnecessarily inhibits the flow of capital into Australia through foreign bank branches and, therefore, increases pressure on the availability and cost of credit to Australian business. It is defective tax policy because it conflicts with internationally accepted transfer pricing norms that rely on arm's length pricing. It also has serious technical flaws, most notably because it is not a representative funding rate for individual banks or for funding at a maturity greater than twelve months.

The absurdity of the LIBOR Cap was exacerbated in 2013 when the British Bankers Association ceased to quote AUD LIBOR. This resulted in a situation whereby there was no applicable LIBOR in respect of AUD borrowings and consequently, in AFMA's view, no cap on the deductibility of interest where the Australian branch borrowed in AUD. This has necessitated agreement between the ATO and AFMA, on behalf of industry, of an Administrative Solution that may be adopted by taxpayers to address AUD borrowings to which the LIBOR Cap previously applied.

During the 2014 calendar year, and at the Government's request, AFMA provided both the Government and Treasury with revenue estimates of the cost of the removal of the LIBOR cap, based on survey responses from its members. These estimates demonstrated that the cost of removal of the cap was immaterial and would deliver significant deregulation benefits, as well as enhancing banking competition. However, a policy announcement that the LIBOR Cap would be abolished did not ensue.

Given the defective nature of the LIBOR Cap from a policy perspective, the impracticality associated with applying the cap for currencies for which no LIBOR is quoted and the immaterial revenue consequences associated with its removal, AFMA again calls on the Government to abolish the LIBOR Cap as a matter of urgency.

5. Specific Deduction for Liquidity Management Costs for Financial Institutions

A fundamental pillar of the financial institution reforms under the Third Basel Accord (**Basel III**) in respect of the prudential regulation of financial institutions is the requirement that financial institutions hold sufficient high-quality liquid assets to cover events of stress. Financial institutions will demonstrate adherence to the principle through compliance with two prescriptive ratios: the "Liquidity Coverage Ratio" and the "Net Stable Finding" ratio.

The maintenance of a sufficient pool of liquid assets to adhere to the Basel III requirements generally results in a significant cost for the financial institutions, properly characterised as a net interest expense. This is due to the fact that interest paid on the

funding used to acquire the liquid assets is typically higher than the return on the investments themselves.

Historically, it has been common for multinational financial institutions to adopt a model whereby management of the liquidity requirements for the ADI has been performed centrally, with the costs of adherence being allocated to the businesses/jurisdictions that give rise to the requirement for the bank to hold the pool of liquid assets.

From a taxation perspective, the economic cost that is incurred from holding the pool of liquid assets should generally be deductible, to the extent that the loss or outgoing is best characterised as the net costs incurred by the institution in holding those the liquid assets. Where a financial institution is managing its liquidity requirements centrally and then allocating the associated costs proportionately, then the allocation ought to be deductible to the financial institution in the jurisdiction in which it operates, subject to adherence to transfer pricing requirements.

However, the ATO, in Interpretative Decision ATO ID 2012/92, has set out its view of the taxation consequences of centralised liquidity management being undertaken by the head office of a multinational financial institution and the allocation of costs to the branches of that institution. The view expressed by the ATO in ATO ID 2012/92 is that, in determining the profits attributable to the foreign bank's Australian branch, the net interest expense incurred by the bank on its borrowings to fund the liquid assets is not deductible under Section 8-1 of the *Income Tax Assessment Act 1997* (**the 1997 Act**). The practical application of this view is that any allocation of the net costs of complying with liquidity standards by the bank to the Australian branch is not deductible. Importantly, such a conclusion will arise regardless as to whether the allocation of the net costs is at arm's length and accords to transfer pricing principles such as those set out in Division 815 of the 1997 Act.

The stance adopted by the ATO potentially gives rise to double taxation and will increase the already significant costs to financial institutions that are compelled to comply with the Basel III liquidity requirements. It is contrary to the policy objectives of banking regulation – while the Basel III objectives would be to encourage financial institutions to hold more liquid assets to better insulate deposit-holders during times of stress, the view adopted by the ATO discourages the holding of these assets through exacerbating their cost through double taxation.

Given the ATO view, AFMA submits that the Government should acknowledge that costs incurred by a financial institution that are referable to the Australian operations of that financial institution, whether incurred directly or allocated to the Australian operations under a centralised model, should be deductible in Australia, with such deduction being limited to the arm's length amount determined with reference to transfer pricing principles as set out in Division 815 of the *Income Tax Assessment Act 1997* and, where relevant, Australia's network of double taxation treaties.

Such a legislative clarification would, in AFMA's view, ensure that Australia is not out of step when compared to other OECD and G-20 nations regarding their stance to adherence to the Basel III liquidity requirements.

6. Withholding Tax on Interest Paid to CCPs

In February 2013, AFMA, the Australian Bankers' Association and the Financial Services Council lodged a submission with Treasury seeking a withholding tax exemption for interest paid to Central Counterparties (**CCPs**).

As part of the G-20's commitment to improving the transparency of OTC derivatives, systemically important OTC derivatives (such as AUD interest rate swaps) are required to be collateralised and cleared through an appropriately structured CCP. The concern expressed in the submission was that where the CCP was located outside of Australia, interest paid on the collateral could result in Australian interest withholding tax.

The submission sought an exemption for any withholding tax that would arise, on the basis that the cross-border interest flow arose solely due to regulatory reform and any withholding tax arising would adversely affect the Australian derivatives market, with the detrimental impacts vastly exceeding any Government revenue.

The point was acknowledged by the Final Report of the Financial System Inquiry, which observed:

> "Australia's IWT regime also applies to derivative transactions. Under G20 commitments, certain standardised over-the-counter need to be collateralised and cleared through a regulated central counterparty. In Australia, outbound interest payments on collateralised positions may be subject to IWT (flows from Australian participants to offshore CCPs, or flows from Australian CCPs to offshore participants). This may increase costs for Australian participants and adversely affect liquidity in Australian derivatives markets."

AFMA has received no response from the Government or Treasury with respect to the submission, nor AFMA's 2014-15 Pre-Budget Submission in which the issue was again raised. This issue continues to be an ongoing threat to the Australian derivatives market and AFMA urges the Government to consider the request made in the submission in the 2015-16 Federal Budget.

7. Disclosure of Tax Payable by Large and Multinational Enterprises

On 29 June 2013, the *Tax Laws Amendment (2013 Measures No. 2) Act* received Royal Assent. Included in this Act was the requirement of the Commissioner of Taxation to publish the following information in respect of corporate taxpayers with annual income in excess of $100 million:

- Total income;
- Taxable income; and
- Tax payable.

AFMA lodged a detailed submission to both Treasury and the Senate Standing Committee on Economics which expressed considerable concern with this proposal. In particular, we noted that the proposed disclosure would arguably mislead the community and not address the perceived phenomenon of stateless income. Our views were mirrored by eminent bodies such as the Corporate Taxpayers' Association and the Law Council.

AFMA's submission was cited with approval by the Coalition's dissenting report, particularly the comment that:

> "Of greater concern is that the disclosure framework could incentivise taxpayers to adopt structures that reduce total income to below $100 million so as to escape the disclosure requirement."

As expressed in our submissions, AFMA believes that the information that is currently provided to the ATO through both the annual Income Tax Return and Schedules and also through compliance products such as Pre-Compliance Reviews should allow the ATO to conduct appropriate compliance activities and prosecute those that have not adhered to their obligations with all of the powers available to the ATO as the administrator of Australia's tax system. The ATO is similarly well-placed to discharge the other purported policy basis for the disclosure of confidential taxpayer information, being to educate the public regarding taxation matters and policies.

We note that the mandatory disclosure of taxpayer information to the public based on an arbitrary threshold is out of step with other G-20 and OECD nations. AFMA agrees that increased transparency of taxpayers' affairs will assist in preventing practices that may be perceived as egregious, but such transparency should not occur through disclosure to the public in a manner that may be construed as misleading.

In advance of the first disclosure by the Commissioner of taxpayer information in late 2015, the Government has an opportunity to remedy the inherently flawed proposal set out in *Tax Laws Amendment (2013 Measures No. 2) Act*.

Appendix A - Capital Protected Borrowing Rules

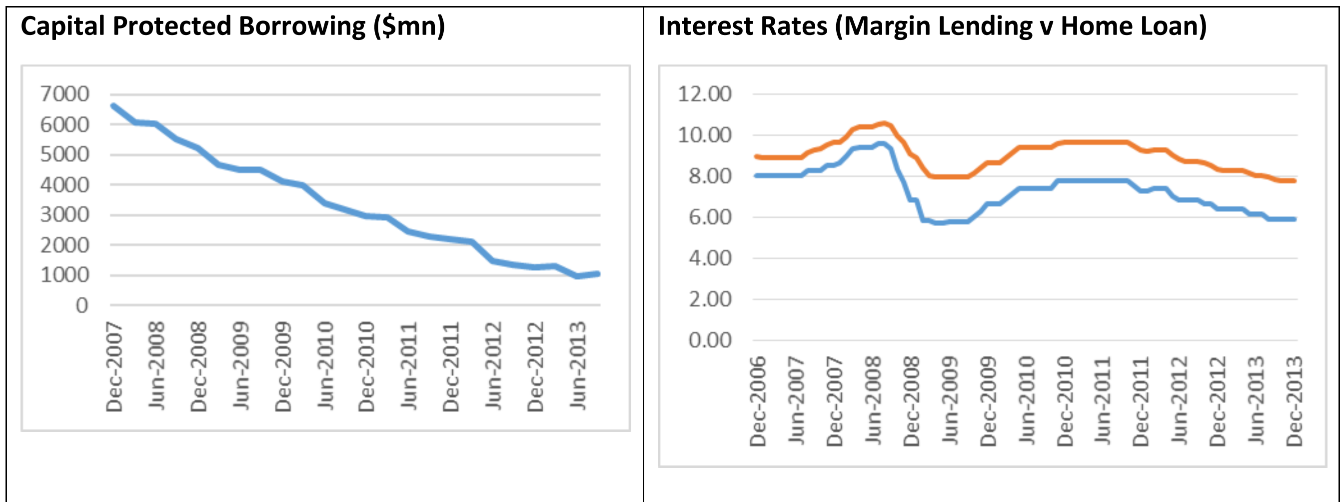
Capital protected products include protected equity loans and instalment warrants. They are an efficient investment tool for retail investors, including many retirees, to manage their financial risk and grow their wealth in a prudent way by investing in the Australian economy.

Schedule 2 of the *Tax Laws Amendment (2010 Measures No. 5) Act 2011* (**TLAB5**) reduced the benchmark rate for the tax deductibility on interest on capital protected borrowings to the indicator home loan rate plus 100 basis points. AFMA advised the Senate Economics Legislation Committee in its inquiry into the related Bill that this level is not a fair reflection of the borrowing costs for investors and it would continue to stymie the market's ability to meet their needs in a cost effective way. Subsequent evidence confirms that our concerns were valid and investors have lost access to cost effective capital protection at the very time that market volatility places a premium on this.

Table 1, set out below, highlights the inefficiencies associated with the reduction of the benchmark rate as set out in TLAB5, namely:

> **Volume** - A continuous decline in market size since the Government announced a greatly reduced benchmark rate in the May 2008 Budget, with total capital protected borrowing amounts in December 2013 exhibiting a reduction of approximately 80% from the peak (December 2007); and
>
> **Price** - The non-deductibility penalty has increased, as illustrated by the increase in the spread between the Margin Lending Rate and the Home Loan Rate between 2007 (average spread of 85-90bbps) and 2013 (spread of approximately 195-210 bps).

Table 1 *(Source – Reserve Bank of Australia Tables F5 and B10)*



In terms of what is an appropriate rate, AFMA agrees with the view provided to the Senate Committee by Treasury, namely that the objective of the benchmark rate is to strike a balance between not inhibiting use of capital protected borrowings and not

stimulating the product by affording them an overly generous tax treatment. Clearly, as evidenced by the Tables above, this balance has not been struck by the current rate.

The current, restrictive rate is entirely inconsistent with the Government's deregulation agenda and adds a layer of complexity and red-tape to investors seeking to protect their investment. Anecdotal evidence from our members suggest that investors are having to spend time and money in completing their tax returns in order to make adjustments for amounts frequently less than a couple of hundred dollars and that this is a disincentive to obtain protection. Changing the rate to one which only affects those investors seeking to claim a deduction that may be perceived as "over-generous" will ensure that the vast majority of investors are not burdened by the compliance costs associated with applying the capital protected borrowing rules.

This was a point agreed with by the Coalition Senators in their Dissenting Report to the Report by the Senate Economics Committee review of TLAB 5, which stated:

> "More persuasive is the establishment of a benchmark rate at the midpoint between the indicator rates for standard variable rate housing loans and personal unsecured variable rate loans, as recommended by the Australian Financial Markets Association. This is an attempt to set a level that equates the cost of the component required for capital protection equivalent to the cost of acquiring separate protection. Given this was the original goal of the legislation in establishing a threshold, it would seem to the Coalition to be the more sensible approach."

Taking into consideration the Government's stated objective of reducing red-tape for both issuers and investors, AFMA acknowledges that another viable option may be to consider setting the deductible rate as equivalent to the margin lending rate. While the margin lending rate is significantly lower than the mid-point between the indicator rates for housing loans and personal unsecured variable rate loans, it has the advantage of being easily obtained and reflective of the real cost of funds associated with investors looking to gear into listed equities and other similar assets. However, the Government needs to be aware that providers of capital protected products take higher credit risk on the holder of the products insofar as the protection cost is generally paid by the investor annually in arrears. As such, the margin lending rate understates the real financing cost associated with such products.

We reiterate that the Government should acknowledge the problem and look to make amendments in the 2015-16 Budget. Under the current rules, investors face higher compliance costs, additional taxation on their investments and a tax bias towards riskier investments, which given current market volatility, is counter-intuitive from a policy perspective. AFMA is seeking a solution that would provide a stable and workable solution that protects tax revenue, enable investors to go about their business in a prudent manner and reduce the likelihood of inadvertent impacts on business.

Appendix B - Tax Black Hole for Retail Investors

An expense in relation to an income earning activity that is not recognised for tax purposes (e.g. a deduction, depreciation or inclusion in capital gains tax cost base) is referred to as a tax black hole. It is widely accepted that a tax black hole is a sign of a deficiency in the efficiency and fairness of our tax system.

AFMA's pre-Budget submission in February 2010 asked the Government to introduce a solution in the 2010-11 Budget for a tax black hole that penalises retail investors. In short, the tax black hole in question exists in relation to non-deductible interest on an investment where a capital gain is not achieved when the investment is realised, which could adversely affect many retail investors in commonly offered financial products.

In response, the Assistant Treasurer advised that the Government had considered AFMA's proposal in framing its 2010-11 Budget but would not proceed with it at that stage due to other priorities. He went on to say that the Government may be in a position to consider AFMA's proposal further in the future.

As noted in AFMA's 2013-14 Pre-Budget submission, we continue to believe it would be timely for the Government to address this issue as a matter of urgency as:

- There is no obvious public policy reason why a tax attribute should not arise in the circumstances considered here and change is required to produce a reasonable and fair outcome for investors;
- Financial market and economic conditions continue to be challenging for retail investors; and
- The issue has already been set aside for five years and, even if a decision is announced in the 2015-16 Budget to make the necessary change, it is unlikely that legislation would be in place before the end of the year.

Appendix C - Tax Black Hole on Staff Termination Payments

The Government and the community expect companies to look after the welfare of their staff. The closure of a business can be a distressing time for employees and companies may endeavour to make redundancy payments in excess of minimum statutory entitlements to assist affected employees. The tax law should not inhibit employers who wish to help their staff in this way. However, staff termination payments made to employees upon the closure of a business may not always be tax deductible to the employer, creating a tax expenditure black hole.

In technical terms, the problem arises from the interaction of s.40-880 and s.25-50 with s.26-55 of the 1936 Act; the latter limits the tax deductibility of a pension, gratuity or retiring allowance paid to an employee. Taxation Ruling TR 2011/6 includes an example that explains ATO's view of the law*:*

> ***Example 34***
>
> *Company T made a payment to an employee in the form of a retiring allowance which meets the conditions for a deduction under section 25-50. However, the payment resulted in the company making a loss for income tax purposes. Paragraph 26-55(1)(a) limits the deduction otherwise available under section 25-50 if the deduction creates or increases a loss for income tax purposes.*
>
> *As a result, the part of the payment to the employee that created the loss is not deductible under section 25-50. As paragraph 26-55(1)(a) expressly prevents part of the payment being deductible under section 25-50, paragraph 40-880(5)(h) excludes that part of the payment from deductibility under section 40-880.*

We believe this outcome conflicts with good tax and social policy. The Ralph Review of Business Taxation considered the tax policy issues and recommended that business closure costs should be made deductible to eliminate a tax expenditure black hole.[1] Staff termination costs may be a significant component of the cost of winding-up a business and they should be fully tax deductible. This outcome is also anomalous given the treatment of related expenditures (eg legal advice on a terminations payment is tax deductible).

Staff termination payments arising in the normal course of winding up a business should be fully deductible. We ask the Government to clarify that its policy is that all *bona fide* staff termination payments are deductible and, if necessary, it should amend the law to provide the required certainty. If there is any concern about tax avoidance, then this should be dealt with separately.

[1] *A Tax System Redesigned*; recommendation 4.14.