6 June 2014

General Manager
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The Treasury
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Via Email: taxlawdesign@treasury.gov.au

Dear Treasury,

Thin Capitalisation Reforms
Exposure Draft Legislation

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.

We welcome the opportunity to provide a submission on the Exposure Draft and accompanying draft Explanatory Memorandum detailing amendments to the thin capitalisation regime in Division 820 of the *Income Tax Assessment Act* 1997 (**the 1997 Act**) and associated changes to the *Income Tax Assessment Act* 1936 (**the 1936 Act**) in relation to the taxation of non-portfolio dividends and changes to the Controlled Foreign Corporation (**CFC**) provisions.

We note the contents of AFMA's submission to the 2013 consultation on the Treasury Proposals Paper entitled "Addressing profit shifting through the artificial loading of debt in Australia," (**the Proposals Paper**) which sets out AFMA's policy position on a number of issues including thin capitalisation and also issues not considered in the Exposure Draft, such as:

- The removal of the "LIBOR Cap" in Part IIIB of the 1936 Act;
- Attribution of capital to Australian bank branches; and

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- The proposed repeal of Section 25-90 of the 1997 Act (which AFMA notes is not to proceed).

AFMA's policy positions in relation to these issues remain unchanged and Treasury's attention is drawn again to this submission in framing the comments set out below.

Non-Extension of Worldwide Gearing Test to Foreign-Controlled ADIs

AFMA is concerned that the Exposure Draft does not, based on a technical reading, extend the availability of the worldwide gearing test to foreign-controlled investing ADIs, be they outward or inward investing.

The Proposals Paper states at Section 4.1.1 that "(a)s part of these reforms, inbound investors will now have access to a worldwide gearing test." AFMA took the view that this extension of the worldwide gearing test would apply to all foreign-controlled investors that are subject to Division 820 of the 1997 Act.

Indeed, AFMA's submission to the Proposals Paper focussed on the benefits associated with extending the worldwide gearing test to foreign-controlled ADIs. In particular, the submission focussed on the ability for foreign-controlled ADIs to utilise a worldwide gearing test to satisfy thin capitalisation requirements where the home prudential regulator was adopting a different timetable in terms of implementing the capital requirements of the Basel III accord. It was noted that as at 1 July 2014, home country prudential regulators would require capital equal to 5.5% of risk-weighted assets to be held to comply with the Basel III requirements. The submission concluded by stating that:

> "It appears that having a level of capital in the branch for thin capitalisation purposes that is consistent with the Basel III capital requirements of the home jurisdiction is consistent with the application of the worldwide gearing test to inbound ADIs. This should be made clear in the legislation and accompanying explanatory material."

From a review of the draft Explanatory Memorandum, there does not appear to be a policy basis for excluding ADIs. The draft Explanatory Memorandum states, at paragraph 1.44, that "(t)he new worldwide gearing test does not apply to ADIs, as these entities apply a separate worldwide capital test." However, the worldwide capital test, set out in Section 820-320 of the 1997 Act, explicitly excludes any entity that is a "foreign controlled Australian entity," which extends to foreign owned Australian branches and subsidiaries, even where they are outward investors for thin capitalisation purposes. Hence, there is not a worldwide gearing/capital test for foreign-controlled ADIs.

AFMA submits that a worldwide gearing/capital test be made available for foreign-controlled ADIs in a manner consistent with the principle of tax neutrality that underpins Division 820. AFMA is keen to assist Treasury to the extent that there are some technical issues that require industry feedback to develop a workable legislative framework.

Alignment of "Prudential Capital Deductions" to "Risk-Weighted Assets"

The Exposure Draft represents an opportunity to rectify a fundamental disconnect in the structure of Division 820 of the 1997 Act as it applies to outward investing groups that contain a foreign bank branch. Under the provisions as they currently apply, such groups are required to determine risk-weighted assets, multiply by 4% and then add the average value of all tier-1 prudential capital deductions.

The disconnect arises from the disparity in the definitions of "risk-weighted assets" and "prudential capital deduction."

"Risk-weighted assets" is defined in Section 995-1 of the 1997 Act as being the sum of the risk-weighted exposures that is determined, for entities that are either foreign controlled, either with reference to the "prudential standards" (meaning the standards determined by APRA) or "the prudential standards determined by the prudential regulator in the country of which the entity, or the foreign bank that has TC interests of at least 40% in the entity, is a resident," i.e. the home country regulator. Hence, for outward investing ADIs that contain a foreign bank branch, there is a choice as to whether to apply the calculation methodology imposed by APRA or the home country prudential regulator.

However, the definition of "prudential capital deduction," under the definition in Section 995-1 of the 1997 Act, "means the total amount that must be deducted…in accordance with the prudential standards." There is no choice to apply the calculation methodology imposed by the home country regulator and the determination of prudential capital deductions must be made with reference to the APRA methodology.

From a policy perspective, AFMA submits that the ability for outward investing ADIs that contain a foreign bank branch to rely on the home country regulator to determine risk-weighted assets should similarly be extended to allow reliance on the home country regulator to determine prudential capital deductions. This would be consistent with the general approach in prudential regulation, as mirrored in the structure of the Australian thin capitalisation rules, to defer responsibility for determining capital adequacy for multinational financial institutions to the home country prudential regulator. Indeed, as noted in the Explanatory Memorandum to the Bill that introduced Division 820:

> "the framework for these rules is provided by the capital adequacy regime that ADIs must meet as part of the licensing regime that APRA and foreign prudential regulators administer."

It is noted that inward investing ADIs (that may contain a foreign bank branch) are not required to include prudential capital deductions in Section 820-405 of the 1997 Act. It is not clear to AFMA as to why the calculation methodologies may apply differently for outward investors that contain a foreign bank branch. From a policy perspective, the ability to level the playing field somewhat by allowing outward investing groups to calculate such prudential capital deductions based on the methodologies adopted by the home country prudential regulator would appear appropriate.

Application of Thin Capitalisation Provisions to Groups containing ADIs and NOHCs

Consistent with the broad approach of the structure of Division 820 of the 1997 Act as the Division applies to ADIs and groups containing ADIs, being alignment with the regulatory outcomes, AFMA submits that the legislation should mitigate, to the extent possible, differences between regulatory requirements and taxation requirements. In particular, and for example, requiring taxpayers to treat their non-operating holding company structures as though the group is an ADI for thin capitalisation purposes results in differences between taxation and regulatory outcomes. We submit that Division 820 be amended to align the thin capitalisation outcomes to the regulatory outcomes in such circumstances.

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Please contact me on (02) 9776 7996 with any queries.

Yours sincerely,

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