8 April 2015

General Manager
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Attention: Michael Atfield/Ronita Ram

Via Email: taxlawdesign@treasury.gov.au

Dear Michael, Ronita

Reforms to Offshore Banking Units
Exposure Draft and Draft Explanatory Memorandum

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. A number of our members hold entities that have been registered under the Offshore Banking Unit (**OBU**) regime.

The Australian Bankers' Association (**ABA**) is the industry association representing its member banks that consist of domestic systemically-important banks, other Australian "internationally-active banks" and a number of domestic and foreign-owned banks which are active in the Australian market.

We welcome the opportunity to provide comments on the Exposure Draft and accompanying draft supplementary Explanatory Memorandum which sets out proposed reforms to the OBU regime. Both AFMA and the ABA have previously provided submissions advocating particular reforms to the regime and this submission is in addition to those. In particular, with regards to the content of the current consultation; comments set out in the following prior submissions remain current and reflect the views of both AFMA and the ABA:

- Improving the Offshore Banking Unit regime, dated 19 July 2013;

Australian Financial Markets Association
ABN 69 793 968 987
Level 25, Angel Place 123 Pitt Street Sydney GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7907 Fax: +61 2 9776 4488
Email: info@afma.com.au Web: www.afma.com.au

- OBU Consultation – Eligible Activities, dated 9 September 2014;
- OBU Consultation – OBU Income/Expenses, Thin Capitalisation and Interest Withholding Tax Issues, dated 12 September 2014; and
- OBU Consultation – Eligible Activities Supplementary Submission, dated 26 September 2014.

The structure of this submission is to provide comments as to the policy approach adopted by Treasury as set out in the Exposure Draft and draft Explanatory Memorandum; particularly in respect of matters not addressed in the Exposure Draft that are, in our view, fundamental to the continuing competitiveness of the OBU regime. This submission then provides comments on the specific reforms as set out in the Exposure Draft. Finally, we set out some technical matters arising from a review of the Exposure Draft.

Policy Approach

Eligible Activities

As detailed in previous submissions, AFMA and the ABA strongly supports the modernisation of the OBU regime through adopting a test for eligibility of activities based on principles as opposed to perpetuating the current "laundry list" approach. AFMA and the ABA maintain that the increasingly uncompetitive nature of the OBU regime which necessitates the current reforms is due, in part, to the legislative framework underpinning the regime. This is particularly the case in an era of financial innovation where transactions are initiated and products developed that may not have been within the knowledge of the legislature at the time of passing. While this issue is ameliorated, to a certain extent, by allowing terms to be defined with reference to their ordinary commercial meaning, the approach adopted in the Exposure Draft represents a wasted opportunity to future-proof the OBU regime and fails to provide the necessary flexibility to ensure it can remain current in the face of change.

At a minimum, AFMA and the ABA continue to support a provision that allows for transactions with offshore persons/other OBUs in respect of a "financial arrangement," as defined in Division 230 of the 1997 Act, are eligible to be conducted by an OBU. As set out in detail in our submissions of 9 September 2014 and 23 September 2014, we do not believe that importing the principles articulated in Sections 230-45, 230-50 and 230-530 of the 1997 Act into the OBU regime would materially expand the range of eligible activities but rather supports the existing policy intent and legislative framework.

Throughout the current consultation process, AFMA and the ABA have not received from either Government or Treasury an explanation as to why the Exposure Draft does not reflect this recommendation and can therefore only assume that resourcing and time constraints, as opposed to a particular objection, resulted in the "laundry list" approach being continued. Accordingly, AFMA and the ABA would welcome the opportunity to continue to engage with Treasury on this important issue to seek further reform.

OB-Money/Purity Test

It is noted that the Exposure Draft does not address or reform the current OB-money and purity test provisions. Briefly, these provisions require that OB-money is used in order for an activity to produce income eligible for the concessional tax rate and limit the amount of use of non-OB money before there is a loss of the concession for the entire year of income (known as the purity test).

As noted in the AFMA and ABA submission of 12 September 2014, the OB-money rules are confusing, complex and particularly difficult to apply in practice. They impose a significant constraint on an OBU's ability to fund its activities as well as imposing considerable administrative and compliance red-tape in terms of tracing funds, despite the inherent fungibility of money, particularly in a banking context. These represent real disincentives to use the regime and are a compelling reason, in our view, as to why the take-up of the regime is sub-optimal. Moreover, given there are no similar requirements in equivalent regimes in other jurisdictions, the OB-money and purity test requirements place the regime at a significant competitive disadvantage.

While we note that the Exposure Draft does not set out any measures to address previously articulated concerns regarding "thickly capitalised" OBUs, this should not of itself lessen our view that the OB-money and purity test rules be removed. Indeed, given some of the integrity measures set out below that enhance the robustness of ensuring that an OBU's internal dealings are at arm's length, the rationale for keeping the OB-money and purity test rules may be less compelling.

Given that both AFMA and the ABA maintain that the OB-money and purity test rules impose a significant fetter on the competitiveness of the OBU regime, as well as being in stark contrast with the Government's deregulation agenda, we again would welcome the opportunity to engage on these matters further.

Custodial and settlement services

A significant aspect of the current consultation in respect of reforms to the OBU regime has been to highlight how the current regime does not cater for the provision of custodial and settlement services and suggesting significant enhancements to the regime to ensure that the OBU was able to conduct activities in Australia with respect to each step of a transaction life-cycle. Our submissions of 9 September 2014 and 26 September 2014 set out our comments in considerable detail on this issue.

Broadly, it was the contention in these submissions that the current drafting of the OBU requirements for eligibility, as they pertain to custodial/settlement services, by requiring that the services be conducted only in context of providing portfolio management services and requiring that the custodian also "manages" the investment, was unduly restrictive. The submissions detailed further technical issues that meant that custodial services were not included as eligible activities in a manner which could be described as consistent or holistic.

Accordingly, AFMA and the ABA are disappointed that the Exposure Draft does not propose any reforms to ensure that the eligibility requirements for custodial and settlement services to be conducted by an OBU. We reiterate that there is clear policy intent for these services to be eligible, but that the mechanics of the provisions are difficult to adhere to. It is pivotal that these services be able to be provided to an offshore person from Australia as they are a fundamental part of a suite of services that may be provided by an OBU, including foreign currency exchange services, cash/collateral management and securities lending. To the extent that only a sub-set of services can be provided from Australia, in all likelihood, these services will be provided from another jurisdiction, which is not a desirable outcome. By ensuring that these provisions operate as intended would increase the potential to attract financial activity into Australia.

Accordingly, AFMA and the ABA again request that the OBU regime be clarified to ensure that the provision of custodial and settlement services operates in accordance with the policy intent, both in relation to such services and the OBU regime more generally.

Hedging activities

As currently drafted, Section 121D(8) currently only extends the ambit of "hedging activity" to address interest rate and foreign currency risks in respect of borrowing or lending activities. This causes considerable issues where OBUs enter into eligible contracts which may pose other risks, such as equity risk and credit risk, and seeks to hedge those risks or where the interest rate and foreign currency risks being hedged is not in respect of a borrowing or lending activity (for example the interest rate / foreign currency risk relates to a "hedged item" that is an eligible leasing activity, rather than a loan). Accordingly, we request that Section 121D(8) be updated to reflect other commercial risks that may arise for an OBU, including equity risk, credit risk, commodity risk and volatility risk and interest rate /foreign currency risks on other eligible OB activities such as the proposed leasing activity inclusion, where the transaction represents a designated hedge.

Specific comments

The "choice principle"

AFMA and the ABA are pleased that the proposed reforms include the codification of the "choice principle" and the ability for the contemporaneous choice to be remedied where it was made in error. This is consistent with our previous submissions, although we note that proposed Section 121EAA(4) appears to operate in only one direction (i.e. correcting a mistake where an OBU amount is booked to the DBU in error, but not vice-versa). Clearly the section should allow rectification on both sides. In addition, clarification is needed that where there is an error such that an ineligible transaction is inadvertently booked to the OBU, there needs to be clarification that the revocation is effective for all purposes, including that there is no use of "non-OB money" in the OBU by virtue of the existence of the transaction in the OBU for a short period of time.

We also note Treasury's advice that a technical issue regarding the choice principle and the refinements to OBU advisory activities and the income allocation rules, given there is no upfront "choice" to book revenues from such activities in either the OBU or the DBU and support this issue being addressed in the final bill.

Our primary concern with the choice principle is the proposed integrity rule in Section 121EAA(3), which states that the OBU is treated as having made a choice where "it is reasonable to regard the transaction and one or more other things done by the OBU as constituting a single scheme" and the OBU has made a choice in respect of one or more of those other things. While the ED refers to the term "single scheme" taking its meaning from the ITAA 1997, it is noted that this term is not asterisked nor is it defined in Section 995-1. Moreover, while AFMA and the ABA understand that the ambit of the rule is to address asymmetric swap transactions, we are very concerned that the ambit of the rule is broader and will disturb ordinary commercial arrangements with no asymmetric outcome.

It is noted that this proposed integrity rule was not the subject of consultation and hence we have only had a very limited timeframe to react to it. Notwithstanding, examples of commercial transactions that could fall within the ambit of the definition of "single scheme" include:

- An umbrella trading agreement between an OBU and an offshore person designed to cover a range of transactions. Under the agreement, it is possible that the transactions that reference AUD underlyings are entered into, and the OBU may seek to hedge those positions through acquiring the physical AUD instruments, which would be ineligible from an OBU perspective. Hence, to prevent an after-tax mismatch, the transaction also should be booked to the DBU. The concern is that the proposed integrity rule would necessitate that all transactions under the umbrella agreement be booked to the DBU to the extent that they may be considered to be part of a single scheme, which we contend would be an unintended consequence.
- A loan facility which provides for multiple lenders within the same client group, whereby tranches borrowed by Australian subsidiaries of the client group would be advanced by the DBU; and tranches borrowed non-resident companies in the client group would be advanced by the OBU. As with the umbrella trading agreement example above, the concern is that the proposed integrity rule would necessitate that all tranches under the facility be booked to the DBU to the extent that they may be considered to be part of a single scheme, which we would contend would be an unintended consequence.
- An OBU with a number of transactions with an offshore counterparty may post and receive collateral (and receive/pay interest) in respect of those transactions in the OBU, notwithstanding that some of the transactions may be booked to the DBU where the associated hedging may not be an eligible OB activity. While the receiving/posting of collateral should be considered to be a separate OB-activity, and may occur on a net basis across a portfolio of transactions, it may be that the transactions and the collateral requirements are considered to be

part of a single scheme and hence, under the proposed integrity rule, all need to be booked to the DBU.

Any integrity concerns regarding asymmetric swap transactions may be better addressed either through a more targeted rule, such as one that is only triggered where the transactions are entered into for the dominant purpose of arbitraging the differential tax rates between the OBU and the DBU, or alternately, to the extent that the OBU and DBU entered into transactions that may be construed as a "single scheme," the arm's length pricing requirement in proposed Section 121EB(4) could apply to eliminate any arbitrage.

Trading activity

Again consistent with previous AFMA/ABA submissions, we note the proposed clarification of the term "trading" for the purpose of determining what is a trading activity to only dealings in related parties where the total participation interest is less than 10% at the time of the proposed transaction. In addition, transactions in entities that are not "trading" under relevant accounting standards will not be considered to be "trading."

AFMA and the ABA are unsure as to the rationale for both tests, i.e. circumstances in which an OBU will hold less than 10% of a total participation interest in an entity but not book the interest in its accounts as being held for trading purposes. In this regard, we note that, with respect to the "participation interest" test, this test in the Exposure Draft is more onerous than what was proposed in previous submissions that focussed on portfolio/non-portfolio interests, as it requires tracing to determine an associate-inclusive participation interest.

The definition around "trading" in proposed Section 121D(4A)(b)(ii) refers to the accounting standards "within the meaning of that Act." This reference is confusing, in that it is unclear as to what Act is being referred to. There is also a requirement to consider changes of intention, i.e. the ED suggests that the test as to whether something is held for "trading" is to occur just prior to the trading activity, which would deal with circumstances where an asset was acquired with the intention of being held as an investment and then the intention changes to one of trading. However the draft Explanatory Memorandum refers to ineligibility "if any of the traded interest was not recorded in the OBU's accounting records as held for trading," which may imply the relevant intention is the one when the instrument was acquired. This should be clarified in the Explanatory Memorandum, with the appropriate position being that it is the accounting treatment at the time of the activity which is relevant in applying the test.

Finally, the Explanatory Memorandum should also clarify that precluding a particular instrument as being eligible for a "trading activity" by virtue of the two tests in Section 121D(4A)(b) does not preclude transactions in the instrument as being eligible under another activity.

Guarantee activity

AFMA and the ABA support the proposed removal of the restriction around certain guarantee activities that remove the requirement that the guaranteed activity occurs

wholly outside Australia and replacement with the requirement that the activities not relate, to a material extent, to a place within Australia. As previously discussed, the issue with the drafting in the Exposure Draft is the ambit of the term "not material" and we are of the view that more examples in the draft Explanatory Memorandum may be beneficial in clarifying the meaning of the term in both the guarantee context and also the leasing context (refer comments below). In particular, in respect of Example 1.5 in the draft Explanatory Memorandum, the underwriting of the insurance of the plane states that "on occasion, the plane will fly to and from Australia, although this is not a significant route in the context of global operations." However, based on discussions with Treasury, AFMA and the ABA understand that, as an example, where a plane flies to and from Australia as part of a normal route, and accordingly remains on the ground in Australia for a period of time, should have a connection with Australia that is "not material." We believe this would be a useful example and would advocate the updating of Example 1.5 accordingly.

In relation to underwriting, the construction of Section 121D(3)(b) is to allow for the underwriting of risk for an offshore person in respect of (i) offshore property or (ii) an event, if the likelihood of the event happening in Australia is not material. This does not allow for the underwriting of risks in respect of immaterial property in Australia to be eligible (i.e. there is no materiality threshold for property) and hence appears to contradict the conclusion in the second paragraph of Example 1.5.

Leasing activities

The comments in relation to clarifying the ambit of the term "material" as it applies to guarantee activities apply equally to leasing activities.

As per previous submissions, AFMA and the ABA are supportive of the inclusion of leasing into the OBU regime and are of the view that the reference to Section 51AD in 121DD(2)(a) is appropriate, particularly noting the existing ATO guidance as to the interpretation of the section.

In terms of the definition of "leasing activity" in proposed Section 121DD(2), we seek clarification on the requirement for the limbs of the definition, specifically:

(i) Whether there are any specific activities that are recognised as falling within Section 121DD(1) but neither limb of Section 121DD(2).

(ii) In relation to Section 121DD(2), whether the differences between the two tests are that proposed Section 121DD(2)(a) relates to leases, i.e. where the right to use is granted by the owner to another person, while Section 121(2)(b) refers to sub-leases, i.e. where the right to use is provided by someone other than the owner, but someone who themselves has been granted the right to use, to another person.

Further examples in the Explanatory Memorandum would be useful in clarifying the intention of this section.

AFMA and the ABA seek clarification of the disposal of OBU leased assets be provided by the inclusion in Section 121DD of a subsection in respect of any arrangement for the disposal of assets previously subject to Section 121DD.

For the avoidance of any doubt, we consider it is necessary to include:

- in Section 121DD specific reference to arrangements subject to Division 250' and
- in Section 121D(8)(a) and (b) reference to OB leasing activity.

AFMA and the ABA note that, some jurisdictions, in particular, the USA prevents foreign persons from directly owning certain assets such as aircraft. As a result, we recommend that Section 121DD(2) include indirect leasing activity where the OBU owns all the equity interests in an offshore entity whose sole activity is leasing to non-Australian tax residents, e.g. the OBU owns all the beneficial interests in a US trust that leases an aircraft to a US airline.

In addition, AFMA and the ABA note that the leasing of large assets is typically done through special purpose companies for commercial reasons (each special purpose company still being within the tax consolidated group). As a consequence, each special purpose company would need to be gazetted as an OBU where external funding was sourced. This is a consequence of the deeming rule in s717-710 only applying for head company core purposes, which does not include interest withholding tax. Practically the need to gazette each special purpose leasing company as an OBU creates extra compliance burden and delay which could impact successfully executing a transaction. This issue could be easily addressed by referencing the OBU withholding tax provisions (e.g. 128GB) to the deeming in s717-710.

AFMA and the ABA note for completeness and support that the role of the OBU in regards to the proposed Section 121DD is as either lessor or lessee.

Commodity trading

As proposed, the amendments to Section 121D(4) require dealing in certain commodities only where the trading is "incidental" to an eligible contract activity. This, in effect, imposes a restriction on the trading of certain commodities while allowing other trading commodities to be traded without restriction.

AFMA and the ABA have previously provided submissions to Treasury, including as part of the current consultation process, setting out why such a restriction is, in our view, inappropriate. Of particular note is the submission of 26 September 2014 and our response to Treasury's Question 29. AFMA and the ABA hold that from a policy perspective, and indeed from an operational perspective, there is no basis for the restriction.

Moreover, the description of the requirement in 1.66 of the proposed Explanatory Memorandum is confusing insofar as it states:

> "(t)he purpose of this amendment is to allow certain commodity trading activities to be eligible OB activities where they are undertaken to hedge

positions in commodity derivatives. However, it is not necessary that the activity involve hedging for it to be eligible."

Securities lending and repurchase agreements

AFMA and the ABA support the amendments and clarification that transactions in respect of both securities lending agreements and repurchase agreements are eligible to be undertaken by an OBU. We understand that it is not the intention that these terms are to be defined and for them to take their ordinary, commercial meaning, we recommend this point to be included in the Explanatory Memorandum when finalised.

Internal financial dealings of an OBU

AFMA and the ABA understand that the rationale for the proposed Section 121EB(4) is to ensure that related party dealings between a part of an entity through which the OBU carries on OB activities in Australia and another part of the entity, whether or not in Australia, are priced at arm's length. Notwithstanding that neither the measure nor its implications were discussed during consultation, we have no core issues with the amendment being included to the extent that it applies to cross-border dealings, as we would expect that this arm's length requirement to be adhered to by existing OBUs.

Given that Section 121EB deems the part of an OBU through which the entity carries on OB activities to be the whole of the legal entity, and deems the other parts of the entity to be separate persons, it would appear that this may mean that Subdivision 815-C of the ITAA 1997 would apply to transactions between OBUs and offshore branches and hence there is already an arm's length requirement. AFMA and the ABA are interested in Treasury's views as to the reason for the comment in the Explanatory Memorandum that "In addition, the transfer pricing rules in Division 815 of the ITAA 1997 may not apply," particularly in a cross-border context.

Of greater concern is that proposed Section 121EB does not deem Subdivision 815-C to apply to ensure that the conditions under which the OBU deals with the offshore branch are arm's length. The effect of the deeming rule in s 12EB(1) may be that Subdivision 815-B applies to dealings between the "OB activities" part of the OBU and an offshore branch of the OBU, whereas Subdivision 815-C applies for the general purposes of allocating income, losses and outgoings between the Australian operations of the entity as a whole and its offshore PEs. Theoretically, therefore, there could be circumstances where different outcomes may arise between the application of proposed Section 121EB and Subdivision 815-C, given that there is no explanation in either the Exposure Draft or the draft Explanatory Memorandum as to what principles govern the determination of what is "arm's length." Clarity would be needed as to the appropriate outcome in this circumstance.

In addition, we recommend that the inclusion of proposed Section 121EB(4) should occur in conjunction with the revision of the OBU requirement in Section 121EA. The current wording of Section 121EA creates much uncertainty in a global markets context and results in interpretations that are out of step with the globalisation of financial services teams and provide disincentives for Australian companies to retain trading functions onshore. The transfer pricing rules and proposed Section 121EB(4), ensures

that functions taken and risks assumed in Australia are included in the Australian tax base and priced at arm's length, thereby removing the need for s121EA in its current form.

Technical amendments

We have identified the following technical issues and suggested amendments that should be reflected in the Bill:

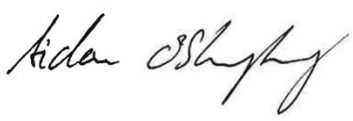
- Proposed Section 121D(4) should cover trading in "options or rights in respect of commodities" in the same way that such "options or rights" are included in current Sections 121D(4)(f) and (g).
- Given the Exposure Draft proposes to insert Section 121EB(4) in relation to arm's length pricing (refer above), it may also be opportune to remove the restriction in Section 121EB, such that the functionally separate enterprise approach that applies to OBUs applies for the purpose of the Division and not just Sections 121D to 121EA (inclusive). This may assist with the transfer pricing/application of Division 815 issue referred to above.
- The current definition of "assessable OB income" in Section 121EE includes amounts either derived from OB activities or "included in the assessable income because of such activities" (Section 121EE(2)(b)). The proposed definition in Section 121EDA, as it applies to ordinary income, only relates to income derived from OB activities of the OBU and hence "because of such activities" limb has been removed. It is not clear as to whether this change was intended – if not the "because of" limb should be inserted into the proposed Section 121EDA definition.

* * * * *

Thank you for the opportunity to contribute to the Exposure Draft and draft Explanatory Memorandum. Both AFMA and the ABA remain committed to continuing our work with Treasury to develop a competitive OBU regime and are happy to engage on any of the matters raised above.

Yours sincerely,

Rob Colquhoun - AFMA



Aidan O'Shaughnessy - ABA