Re:think – Better Tax System, Better Australia

Tax Discussion Paper

June 2015

TABLE OF CONTENTS

1. Summary of Key Recommendations....3
2. Introduction....4
2.1 About AFMA....4
2.2 AFMA's Approach to the Discussion Paper....4
2.3 Alignment of Tax and Regulatory Outcomes....5
2.4 Fiscal Parameters....5
2.5 Observations of the Final Report of the Financial System Inquiry....6
2.6 Other "Taxes" being Considered as part of the Financial System Inquiry....6
2. Corporate Tax Rate....7
3. Dividend Imputation....8
3.1 Introductory Comments....8
3.2 Dividend Imputation System and Corporate Bond Market....8
3.3 Refundability of Franking Credits....9
4. Negative Gearing and CGT Discount....10
4.1 Introductory Comments....10
4.2 Deductibility of Interest....10
4.3 Taxation Treatment of Savings....12
5. Inbound Investments – Foreign Bank Branches....14
5.1 Foreign Bank Branch Issues....14
5.2 LIBOR Cap....16
5.3 Release of Board of Taxation Report into Permanent Establishments....18
6. Inbound Investments – Interest Withholding Tax....19
6.1 Phase-Down of Interest Withholding Tax for Financial Institutions....19

6.2 Section 128F 21

6.3 Interest Withholding Tax Exemption for Interest Paid To/From CCPs 22

6.4 More Enduring Reform of Interest Withholding Tax 23

7. Export of Financial Services 25

7.1 Offshore Banking Unit Regime 25

7.2 Alignment of Free Trade Agreements to Tax Treaties 26

8. Losses 27

9. GST and Indirect Taxes 28

9.1 GST Treatment of Financial Supplies 28

9.2 The RITC Regime 29

9.3 International Comparisons 29

10. Financial Transactions Tax 31

1. Summary of Key Recommendations

	Recommendation
1	That the Government makes a formal commitment to adopt a "whole of government" approach to tax and regulatory policy by giving priority to the design and implementation of measures that are co-ordinated and promote consistent policy outcomes.
2	That a reduction in the company tax rate be prioritised so as to enhance Australia's competitiveness with other jurisdictions in the region.
3	That the dividend imputation system be retained.
5	That the deductibility of interest incurred to acquire an income producing asset not be disturbed across any asset class.
6	That Division 247 of the 1997 Act be amended to remove the bias against capital protection and to ensure that amounts incurred by investors referable to the cost of funds are generally deductible.
8	That Part IIIB of the 1936 Act be retained as the primary code for taxing foreign bank branches.
9	That the modernisation of Part IIIB be prioritised to ensure that it remains contemporaneous, including the adoption of a more principles-based approach.
11	That the Government proceed with the abolition of the LIBOR cap as a matter of urgency.
12	That the Board of Taxation report into the tax arrangements applying to permanent establishments be released, together with the Government response to the recommendations contained therein.
13	That the phase-down of interest withholding tax for financial institutions again be committed to and implemented.
17	That reform to modernise the Offshore Banking Unit regime be continued such that it enhances Australia's financial service exports.

2. Introduction

2.1 About AFMA

The Australian Financial Markets Association (**AFMA**) is the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets, including the capital, credit, derivatives, foreign exchange and other specialist markets.

We have more than 130 members including Australian and international banks, leading brokers, securities companies, state government treasury corporations, fund managers and energy traders. Our role is to provide a forum for industry leadership and to advance the interests of these market participants.

Our mission is to:

- Promote Australia as a global centre for financial services;
- Help members grow their businesses and contribute to Australia's economic wellbeing;
- Develop new markets for financial products;
- Encourage existing markets to reach their full potential;
- Lead and sustain effective management of OTC financial markets;
- Represent market participants in exchange-traded markets to ensure effective and efficient market processes and regulation;
- Encourage high standards of professional conduct;
- Develop individual expertise through professional development and accreditation programs; and
- Promote government policies and business conditions that support a strong financial sector.

2.2 AFMA's Approach to the Discussion Paper

AFMA's submission to the Tax Discussion Paper "Re:Think – Better Tax System, Better Australia" (**the Discussion Paper**) sets out our view, as articulated to us by our members, of the priority issues to be considered as part of enduring tax reform. We are pleased that the Discussion Paper leaves very little off the table, but this approach has resulted in an incredibly broad project that necessitates a judicious approach to the matters raised in our submission. We would be pleased to provide feedback on specific proposals from Government that are not raised in our submission but nonetheless would impact the AFMA membership.

While we acknowledge the breadth of the Discussion Paper, we are concerned that the Government appears to be ruling out reform in certain areas and would caution against the Government pre-empting the outcomes of the current review. We acknowledge that not all aspects of the review will be implemented in the short to medium term but it is crucial, in our view, that the review address all aspects of the system in order to provide a framework for its long-term improvement.

Given our broad church of members, we adhere to certain principles in our submissions and representations, and these are reflected in our submission to the Discussion Paper. In particular:

- Our policy positions are predicated on a free-market philosophy, and emphasise the importance of market discipline to the efficient operation of the financial markets;
- We advocate for market based solutions and only support regulatory intervention where there is demonstrated market failure; and
- Our policy positons aim to be competitively neutral and broadly promote competitive neutrality.

2.3 Alignment of Tax and Regulatory Outcomes

One principle that AFMA believes should underpin the tax reform process, particularly in the current environment of significant regulatory change, is that regulatory and other changes should be approached from a holistic perspective, with the Government 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.

In other words, we need to get the interaction between tax and financial sector policies right and we have failed to do this adequately in the past.

For instance, 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, just as it did through aligning the thin capitalisation minimum capital requirement for banks from 4% to 6% of risk weighted assets to align with the Basel III requirements. Further, a number of announced tax measures designed to promote competition in the financial sector, like interest withholding tax reform, have been sidelined as the political and economic situations have evolved.

To address this problem:

- There needs to be a co-ordinated, whole of government approach to policy implementation by the Government and its agencies; and
- The Government needs to strike a balance between taxation and regulation policy that attaches a higher priority to the future development of the financial system.

Recommendation 1: That the Government makes a formal commitment to adopt a “whole of government” approach to tax and regulatory policy by giving priority to the design and implementation of measures that are co-ordinated and promote consistent policy outcomes.

2.4 Fiscal Parameters

AFMA agrees with the fundamental principles of efficiency, fairness and simplicity in assessing the relative merits of particular taxes. However, we would add that a further constraint be imposed in the current review, being one of revenue neutrality. More

specifically, AFMA advocates a clear articulation from Government that the overall tax burden does not increase as a percentage of GDP as part of the tax reform process.

2.5 Observations of the Final Report of the Financial System Inquiry

The Final Report of the Financial System Inquiry (**FSI**), as handed down in November 2014, did not make any recommendations in relation to tax matters, but rather made a number of observations to inform the Discussion Paper, as set out in Appendix 2 of the Final Report. In addition, the Treasurer announced at the time of the release of the Final Report that it would not be allowing consultation on taxation matters through the FSI consultation process.

Accordingly, to ensure there is no gap in process, it is incumbent upon the Tax Discussion Paper process to clearly address each of the observations made in the Final Report as they pertain to tax. Our submission addresses a number of these, including:

- Interest withholding tax, and specifically the applicability of interest withholding tax on payments made to and from central counterparties;
- The LIBOR Cap;
- Negative gearing and capital gains tax;
- Dividend imputation; and
- GST on financial supplies.

It is important that the Discussion Paper process does not delay reforms already being contemplated. For example, the recommendation of the Johnson Report to abolish the LIBOR cap was considered in a Board of Taxation review into the taxation arrangements for permanent establishments that has been concluded but not released.

2.6 Other "Taxes" being Considered as Part of the Financial System Inquiry

For completeness, we note that there are some measures that are being consulted upon through the FSI process that may be construed as taxation measures. Given that we are engaging directly with the Government on these matters, they have not been set out in our submission below; however we are happy to include as part of our response to the Tax Discussion Paper if desired.

These matters are:

- Regulator funding and cost recovery arrangements, which under the Government's Cost Recovery Guidelines need to be enacted as a taxation measure; and
- Any proposed bank deposit levy, as currently sits in the Budget forward estimates, where the proceeds are directed to consolidated revenue.

2. Corporate Tax Rate

> ***How important is Australia's corporate tax rate in attracting foreign investment? How should Australia respond to the global trend of reduced corporate tax rates?***

AFMA has long maintained that Australia's high corporate tax rate, and indeed its high reliance on corporate tax as a revenue base, hinders the ability of Australia to attract foreign investment. This is particularly important as Australia is a net importer of capital and hence is reliant on such foreign investment to fund its further growth. While the corporate tax rate alone is not the only tax disincentive for Australia as a destination for foreign capital, it is clearly an area where we have been slipping and tangible improvements can be made.

The case for a reduction in the corporate tax rate has been well made in Australia for a considerable period of time. As recently as 2012, the Business Tax Working Group (**BTWG**) was tasked by the then Government to reduce the corporate tax rate in a manner that was revenue neutral. While the BTWG was ultimately unable to agree to the "trade-offs" that would be made in order for such a corporate tax cut to proceed, in AFMA's view this was a function of the revenue-neutral aspect of the Terms of Reference provided by the Government to the BTWG, as opposed to a reflection on the importance of the reduction in the corporate tax rate. AFMA notes with approval the comments from the BTWG's Draft Final Report, which stated:

> "(a) reduced rate would lead to greater investment in Australia in the longer term, which would contribute to improved productivity and higher wages for Australians…Australia should have an ambition to reduce its company tax rate as economic and fiscal circumstances permit."

In our view, the case for a reduction in the corporate tax rate is more pressing then it was in 2012. This was highlighted by the 2014 International Tax Competitiveness Index, where Australia ranked as 24th out of 34 OECD nations in terms of corporate tax, primarily due to a corporate tax rate which ranked 26th out of the 34 countries. This may be compared to 2001, when Australia reduced its company tax rate from 36% to 30%, at which point its rate was the 9th lowest in the OECD.

To the extent that Australia's dividend imputation system operates as a withholding tax as opposed to a final tax, at least in terms of resident shareholders receiving franked dividends, then there is a discrepancy between the headline corporate rate of 30% and the actual amount of revenue raised that is referable to corporate taxation. However, this discrepancy only exists in relation to domestic shareholders that enjoy the benefits of imputation, and not the non-resident investors whose capital Australia is seeking to attract.

Recommendation 2: That a reduction in the company tax rate be prioritised so as to enhance Australia's competitiveness with other jurisdictions in the region.

3. Dividend Imputation

Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?

3.1 Introductory Comments

AFMA strongly supports the continuation of the dividend imputation system. There are undoubted benefits arising from the system, including the reduction of bias between equity and debt financing and aligning the taxation outcomes between incorporated and unincorporated business structures. Further, we agree that the imputation system, and the value attached to franking credits by shareholders, fosters integrity in the Australian tax system and provides a significant incentive for companies with Australian shareholders to pay tax in Australia.

Our support for the imputation system acknowledges the comments included in the Final Report of the Financial System Inquiry, and we agree that in an environment of enhanced capital mobility, particularly for a nation that persistently runs current account deficits and is hence reliant on foreign capital, it is appropriate for the review to consider the settings around the current dividend imputation system, i.e. the review should consider the balance between fostering the growth of the Australian economy and not providing a disincentive for foreign investment. We agree with the observation made in the Final Report of the Financial System Inquiry that any distortions that arise from the current system would be mitigated through a reduction in the corporate tax rate.

Recommendation 3: That the dividend imputation system be retained.

3.2 Dividend Imputation System and Corporate Bond Market

In addition to the observations made in the Discussion Paper regarding the imputation system not attracting foreign investment and indeed incentivising Australian shareholders investing in Australian companies that pay Australian tax, a further distortion may arise in respect of the role the imputation system has on companies' dividend policies and consequences for the corporate bond market.

As was noted in the Final Report of the Financial System Inquiry, the development of Australia's corporate bond market has been constrained by a range of factors, including the imputation system. While theoretically one may expect that given the deductibility of bond yields and the frankability of dividends and other returns on equity, investors would be indifferent between returns on debt and equity interests to the extent that the returns on the bonds were grossed up for the deduction. However, in practice, Australian companies are incentivized ensure that dividend payout ratios are struck at a level to ensure that an optimal level of franking credits are passed on to their shareholders, as opposed to being "trapped" in the company.

To that end, and pursuant to the observations of the Financial System Inquiry, the review should consider the impact of imputation on the development of the Australian corporate bond market.

Recommendation 4: That the impact of the current dividend imputation system on Australia's corporate bond market be considered.

3.3 Refundability of Franking Credits

In 2000, the Government amended the imputation system to allow for excess credits to be refunded for those taxpayers with a marginal tax rate below the corporate tax rate. The effect of this measure was to alter the dividend imputation system as a system for the alleviation of double tax to one that treats company tax purely as a withholding mechanism, with company profits being taxed at the investor's marginal rate.

AFMA notes that the basis for the change to the imputation system to allow the refundability of franking credits was set out in the Press Release accompanying the change as:

> "As a result, self-funded retirees, and other low income resident individuals, will no longer face an effective rate of tax on their investments in entities greater than their marginal rate. For superannuation funds, non-refundability of imputation credits can distort investment decisions.

In this light, we note the comment of the Final Report of the Financial System Inquiry, namely:

> "(i)f global capital markets set the (risk adjusted) cost of funding, then dividend imputation acts as a subsidy to domestic equity holders. That would create a bias for domestic investors, including superannuation funds, to invest in domestic equities."

Accordingly, to the extent that the current review considers the settings around the dividend imputation system, a key factor to consider is the extent to which the system, and particularly the refundability of franking credits, distorts investment decisions.

4. Negative Gearing and CGT Discount

To what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?

Do the CGT and negative gearing influence savings and investment decisions, and, if so, how?

4.1 Introductory Comments

AFMA has a steadfast view that costs attributable to earning assessable income should be deductible. In our experience, tax rules that restrict interest deductibility in a financial markets context have been harmful, as outlined below. However, AFMA does not have a position on the social policy factors that may be specifically relevant to negative gearing and the deductibility of interest for investment properties.

We note that negative gearing is not restricted from an asset class perspective, nor is it an explicit concession within the Australian taxation system. While negative gearing is a long standing feature of the Australian economy, coming to prominence long before the CGT discount was introduced, the joint operation of negative gearing and the CGT discount does influence investment decisions. Therefore, it is a relevant feature of the tax system in assessing the need for tax reform and the design of any associated measures.

Negative gearing is a product of the architecture of Australia's taxation system, in particularly, the deductibility of interest incurred to acquire an asset that produced assessable income and the CGT discount that applies where individuals and complying superannuation entities dispose of an asset that has been held for more than 12 months and the asset is held on capital account. It is important to acknowledge that such an outcome may exist for investments in all assets, including listed equities and other financial products.

The CGT discount was a replacement for capital indexation for tax purposes, so there may be a question about the need to further evolve the rules, including by taking account of the interaction with interest deductibility. AFMA believes the economic objectives of the CGT discount remain valid and the question is how well it operates in achieving them within the framework of the taxation system as a whole (i.e. including its interaction with other parts of the tax system).

4.2 Deductibility of Interest

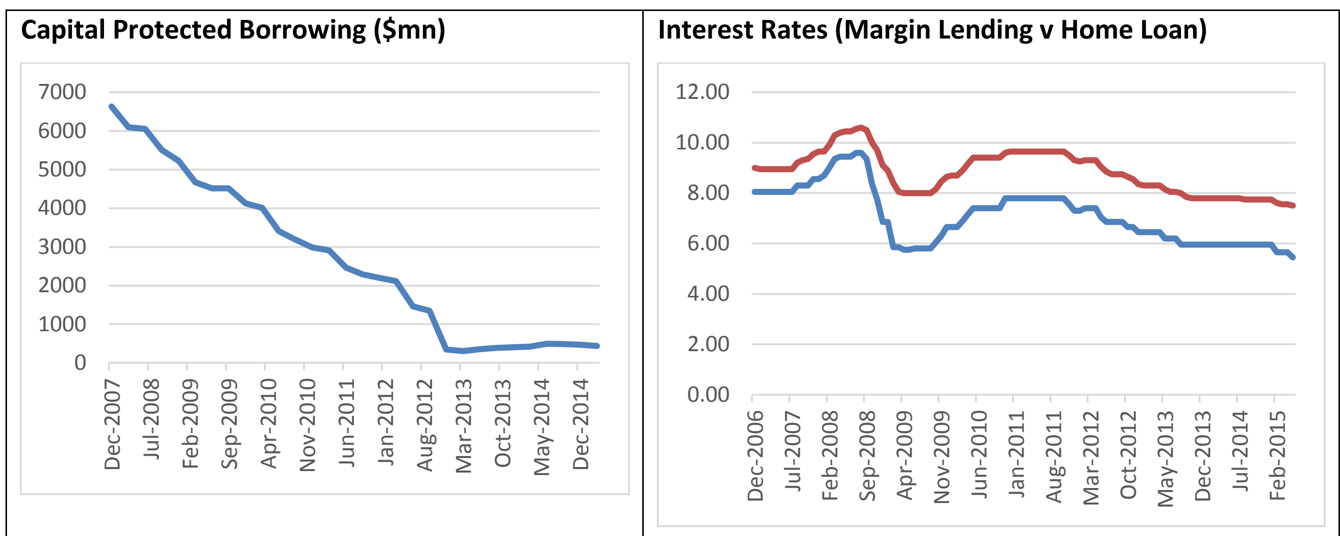
The deductibility of interest where the loan funds are applied to acquire an income producing asset is a fundamental tenet of Australia's tax system and we would strongly caution against any amendments that would disturb this principle. This is even the case where any such amendments were quarantined for residential properties, as this would create distortions and arbitrary outcomes for particular investors.

Deductibility of interest incurred to acquire securities and other financial products has been a significant issue for AFMA members, as issuers of such products, since the advent of the "Capital Protected Borrowing" rules, as set out in Division 247 of the 1997 Act, acts to split a loan incurred to acquire an income producing asset into two artificial components, namely an underlying loan and a deemed put option, where the loan has an element of capital protection. In effect, the provisions limit the deductibility of interest to the amount attributable to the underlying loan.

The mechanics of the provisions operate to limit the deductible interest to a benchmark rate of the indicator home loan rate plus 100 basis points. AFMA has maintained that this rate is not a fair reflection of the borrowing costs for investors and stymies the market's ability to meet investors demands for capital protection, especially at times when market volatility would suggest that such protection would be prudent.

Table 1, set out below, highlights the inefficiencies associated with the implementation of the benchmark rate, 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 2014 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 2015 (spread of approximately 185-210 bps). *(Source – Reserve Bank of Australia Tables F5 and D10)*



The practical effects of these provisions are that investors have higher compliance costs and additional tax obligations in respect of capital protected investments, which then creates a tax bias for riskier products without protection. This is counter-intuitive from an investor-protection policy perspective.

Accordingly, our recommendation would be that deductibility of interest incurred to acquire an income producing asset is maintained, and further that the capital protected borrowing rules be re-evaluated so as to strike an appropriate balance between the costs

incurred by investors that are actually referable to the economic costs of acquiring capital protection, so as to remove any bias that currently exists with respect to such products.

Recommendation 5: That the deductibility of interest incurred to acquire an income producing asset not be disturbed across any asset class.

Recommendation 6: That Division 247 of the 1997 Act be amended to remove the bias against capital protection and to ensure that amounts incurred by investors referable to the cost of funds are generally deductible.

4.3 Taxation Treatment of Savings

AFMA acknowledges the disparity in taxation treatments of various savings vehicles, and particularly the different treatment of capital gains versus other savings income, such as bank deposits. Such differences may provide disincentives for investors to invest in certain products and, in the words of the Final Report of the Financial System Inquiry, potentially "distort the asset composition of household balance sheets and the broader flow of funds in the economy."

It does not necessarily follow, however, that such a disparity necessitates a change to the CGT discount. The CGT discount, which is applied at a rate of 50% for individuals and 33⅓% for complying superannuation entities, is designed to promote the deployment of mobile capital to its best destination and to encourage investment. It was introduced to replace the previous regime of indexation of cost base to ensure the non-taxation of inflation, with the Ralph Review articulating its rationale as follows:

> "there is an inherent tension between rewarding patient investors and seeking to free up capital markets. Realisation based capital gains tax systems generally suffer from a tendency to lock asset holders into less than optimal positions. Providing any further reward for delaying realisation (for example, by a stepped rate related to holding period) would, in some cases, exacerbate the lock-in effect."

In the eyes of the Ralph Review, the move from indexation to a CGT discount would encourage participation in the Australian equities markets and enhance the attractiveness of start-up entities as a destination for mobile capital. In AFMA's view, the promotion of these policy objectives has been a feature of the CGT discount, and there is a case for retention of the discount along similar lines, particularly given that capital losses are quarantined and not able to be offset against other income.

To address the relative disincentives from investing in other savings vehicles, the taxation treatment of such vehicles could be improved so as to reduce such disincentives. To this end, AFMA notes and supports the recommendation of the Henry Review sought to standardise the taxation treatment of various income streams and provide a broad discount for non-business related:

- Net interest income;
- Net residential rental income;
- Capital gains (and losses);

- Interest expenses related to listed shares.

In making this recommendation, the Henry Review agreed with the concerns expressed by the Ralph Review regarding the lock-in effect, and hence provided tacit approval for the GST Discount from a tax law design perspective. AFMA notes the implementation issues that were articulated by the Henry Review but considers such a standardisation as attractive from a policy perspective.

Recommendation 7: That standardisation of the taxation treatment across different taxation vehicles be considered so as to reduce existing distortions.

5. Inbound Investments – Foreign Bank Branches

To what extent should the tax system be designed to attract particular forms of inbound investment (for example, by distinguishing between active or passive income or portfolio and non-portfolio)? If so, what principles should inform this?

5.1 Foreign Bank Branch Issues

AFMA members include foreign banks that generally conduct wholesale business in Australia through an APRA regulated permanent establishment. As set out in further detail below, the tax settings that apply to a foreign bank branch may differ both relative to outbound banks and also other inbound banks, due to different tax regimes and depending on certain choices that may be made by Australian branches of foreign banks.

AFMA generally supports competitive neutrality as a guiding principle to shape the taxation settings that apply to inbound and outbound enterprises that operate in the same markets. To that end, we have highlighted below two particular policy settings that apply to foreign bank branches that, in our view, undermine this broad principle and inhibit the ability of foreign bank branches to compete.

5.1.1 Part IIIB

Part IIIB, as set out in the 1936 Act, operates as a separate regime for the taxation of Australian branches of foreign banks and provides particular treatment to determine taxable income, with branches able to elect out of Part IIIB where the head office is located in a jurisdiction that has concluded a Double Taxation Agreement with Australia.

Broadly, AFMA and its members support the retention of Part IIIB as the primary regime for the taxation of Australian branches of foreign banks. While there are a number of technical deficiencies with respect to Part IIIB, we believe that Part IIIB is an important mechanism to provide certainty to foreign banks acting at or through Australian branches through the recognition of intra-entity dealings.

Recommendation 8: That Part IIIB of the 1936 Act be retained as the primary code for taxing foreign bank branches.

5.1.2 Modernisation of Part IIIB

As noted above, there are a number of technical deficiencies that arise with respect to the application of Part IIIB.

For example, Section 160ZZV of the 1936 Act defines a "derivative transaction" as being a Division 230 financial arrangement that is entered into "for the purpose of eliminating,

reducing or altering the risk of adverse financial consequences that might result from changes in rates of interest or changes in rates of exchange between currencies…"

This definition embodies a quite dated understanding of financial markets and it is clear that the risks that an Australian branch of a foreign bank may look to manage or hedge with its head office encompass more than just interest rate and currency risk. As an example, he recent Treasury Proposals Paper regarding the implementation of Australia's G-20 over-the-counter derivative reform commitments noted five distinct derivative classes, namely:

- Interest rate derivatives;
- Foreign exchange derivatives;
- Credit derivatives;
- Equity derivatives; and
- Commodity derivatives.

From a policy perspective, we do not see a compelling reason to limit the transactions to which Part IIIB applies to only those which assist in the management of interest rate and currency risks. From a policy perspective, we would welcome modernising the definition of "derivative transaction" in Section 160ZZV to encompass more than just interest rate and currency risks, so as to support the full range of current and potential derivatives that could be entered into between the Australian branch and its parent. This could be done by ensuring that all "Division 230" financial arrangements are covered by Part IIIB. This will ensure that Part IIIB remains current in light of future financial market and regulatory developments.

Recommendation 9: That the modernisation of Part IIIB be prioritised to ensure that it remains contemporaneous, including the adoption of a more principles-based approach.

5.1.3 Eligibility to Opt Out of Part IIIB

Under Section 160ZZVB(2), where the taxable income of the foreign bank branch would have been less through not applying Part IIIB, the branch is able to elect that Part IIIB does not apply, but only where "an agreement (within the meaning of the *International Tax Agreements Act* 1953) that has the force of law applies in relation to the bank." This means that those foreign bank branch that are headquartered in a treaty jurisdiction are the only branches eligible to elect out of Part IIIB.

As understood by AFMA, the basis for this provision's inclusion in Part IIIB is to ensure that the regime does not operate in contravention with any Double Taxation Agreement. However, as Part IIIB becomes more dated and less relevant to current businesses being carried on by foreign bank branches in Australia, this restriction compromises competitive neutrality for foreign bank branches operating in Australia based solely on head office location, as only a sub-set of foreign bank branches are eligible to opt-out of Part IIIB.

Accordingly, we would submit that the existence of Section 160ZZVB(2) renders modernisation of Part IIIB as more urgent to as to reduce incentives for branches to elect out of the regime and hence restore competitive neutrality.

5.1.4 Section 160ZZZI

Section 160ZZZI provides that any transaction entered into by a foreign bank, other than through its Australian branch, whereby finance is provided to the bank (such as a loan) or is a derivative or foreign exchange transaction, is to be disregarded when determining whether a deduction is allowable to the branch. The aim of the section is to prevent double counting of deductions.

In practice, however, the operation of the section is unclear, particularly where the transaction undertaken by the bank (not referable to its Australian branch) is not a transaction to which Part IIIB applies, such as a credit default swap. While the Explanatory Memorandum accompanying the enactment of Section 160ZZZI suggests that the rationale for the section's existence is that "Part IIIB provides the only mechanism for attributing the costs of such transactions to the branch," in practice as Part IIIB becomes outdated, the application of Section 160ZZZI has become increasingly ambiguous, with such uncertainty being sufficient for eligible branches to elect out of Part IIIB. Accordingly, we request that either Section 160ZZZI be deleted or its application be clarified.

Recommendation 10: That the application of Section 160ZZZI either be clarified or the section be deleted.

5.2 LIBOR Cap

A particularly concerning aspect of Part IIIB is the so-called "LIBOR Cap," as set out in Section 160ZZZA(1)(c) of the 1936 Act. This provision operates to cap the deductibility of interest paid by a foreign bank branch on funds borrowed from its parent to the applicable LIBOR. AFMA has long maintained that the LIBOR Cap is inconsistent with appropriate competition, regulatory or tax policy and continues to strongly recommend the removal of the LIBOR Cap.

The taxation inequities imposed by the LIBOR Cap was one of a number of factors that contributed to a sharp decline in market share held by foreign banks when compared to the levels exhibited prior to the GFC. Foreign bank branches provide competition in the wholesale banking and financial markets, which benefits Australian business and the broader community. Thus, the LIBOR Cap has the effect of reducing bank competition by increasing the funding costs for foreign banks and thereby hinders the ability of foreign banks to compete in the business loan market. It can be especially penal for new market entrants who may have greater reliance on parent funding as they establish their business and funding capacity in Australia.

Further, to the extent that the LIBOR Cap unnecessarily inhibits the flow of capital into Australia, it increases the availability and cost of credit to Australian business. Abolition of the LIBOR Cap would be viewed as a welcome step towards allowing Australia to compete with regimes such as Singapore and Hong Kong. The abolition would encourage foreign banks to conduct more business in Australia and help provide the critical mass and diversity of business required to sustain financial services exports at the desired level.

Moreover, the LIBOR Cap is unique to Australia and the concept is hard to understand for both tax and non-tax managers in a foreign bank's head office and, rightly or wrongly, creates an impression of risk. It presents the Australian tax regime as being complex, hard for senior management overseas to understand and unwelcoming to banks that wish to transfer funds into the Australian economy through a branch operation.

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 safe harbour that may be adopted by taxpayers to address AUD borrowings to which the LIBOR Cap previously applied.

The continued existence of the LIBOR Cap is particularly perplexing given the number of reviews that have called for its abolition. The 2010 report conducted by the Australian Financial Centre Forum into Australia as a financial centre (**the Johnson Report**), in recommending the abolition of the LIBOR Cap, stated:

> "in periods of stress in credit markets there can be appreciable differences between the LIBOR rate and the rates at which parent banks are able to offer their Australian branches on a commercial basis…any tax avoidance concerns resulting from removing the LIBOR cap could be adequately dealt with by applying the usual transfer pricing guidelines."

This was a theme picked up by the Final Report of the Financial System Inquiry, which observed:

> "(f)or foreign bank branches in Australia, interest paid on funds borrowed from the offshore parent is deductible, limited to the London Interbank Offered Rate (LIBOR) cap. This can prevent the branch from claiming the full interest cost of borrowing."

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 recommends that the LIBOR Cap be abolished as a matter of urgency.

Recommendation 11: That the Government proceed with the abolition of the LIBOR cap as a matter of urgency.

5.3 Release of Board of Taxation Report into Permanent Establishments

Each of the matters addressed above was detailed in AFMA's submission to the Board of Taxation review into the Tax Arrangements Applying to Permanent Establishments, with the Board's report delivered to the then Government in April 2013 and redelivered to the present Government subsequent to the September 2013 election. Notwithstanding the fact that the Board's report has been delivered twice to Government, it has not been released publicly, nor has the Government's response to the matters detailed in the Report.

The failure to release the Report has caused significant issues for entities that operate globally via permanent establishments, in particular many of AFMA's members that are ADIs (both outbound and inbound). This is an area of significant ambiguity as to the appropriate tax settings, particularly given Australia's failure to adopt the most recent iteration of Article 7 in the OECD Model Tax Convention, which authorises the adoption of a functionally separate enterprise 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 has resulted, in an Australian context, in a system that deems branches to be separate enterprises for certain purposes of the Act (Offshore Banking Unit, Part IIIB for qualifying activities) but not for other purposes, and has necessitated engagement with the ATO to ensure that there are common understandings as to how routine transactions that are conducted inter-branch are treated for tax purposes, with such engagement being undertaken in a policy vacuum.

Accordingly, it is imperative in AFMA's view that the Board's report into permanent establishments be released publicly, preferably accompanied by a Government response, to guide reform of the manner in which permanent establishments are treated for Australian tax purposes.

Recommendation 12: That the Board of Taxation report into the tax arrangements applying to permanent establishments be released, together with the Government response to the recommendations contained therein.

6. Inbound Investments – Interest Withholding Tax

To what extent should the tax system be designed to attract particular forms of inbound investment (for example, by distinguishing between active or passive income or portfolio and non-portfolio)? If so, what principles should inform this?

6.1 Phase-Down of Interest Withholding Tax for Financial Institutions

The Discussion Paper cursorily mentions the imposition of interest withholding tax, where it states (at p95):

> "interest withholding tax can increase the cost of funding from overseas, which may lead to lower investment in Australia. The impact of interest withholding tax is discussed in more detail in the final report of the Financial System Inquiry."

Such a cursory description of the effects of interest withholding tax undermines the significant debate and consensus across a number of reviews that endorse the phase-down of interest withholding tax, particularly for financial institutions. This is a policy reform that AFMA has recommended be adopted over a long period, given the importance of Australia as an attractive destination for foreign funding and should be a key focus of the Tax White Paper. The issue is set out in greater detail below.

6.1.1 Background to the Phasing Down of Interest Withholding Tax for Financial Institutions

The Johnson Report

In November 2009, the Australian Financial Centre Forum (**AFCF**) released its report entitled "Australia as a Financial Centre: Building on our Strengths" (the **Johnson report**). This report contained a number of recommendations to promote Australia as a financial services centre.

In the Johnson Report, the AFCF expressed the view that "the application of interest withholding tax to offshore borrowings by Australian based banks is inconsistent with Australia's need, as a capital importing country, to access a diversity of offshore sources of funding." The AFCF went on to state that:

> "the continuing application of interest withholding tax on financial institutions' borrowing offshore sits uneasily with the Government's desire to develop Australia as a leading financial centre and is putting Australia at a competitive disadvantage with respect to overseas financial centres."

Accordingly, the Johnson Report recommended that interest withholding tax be removed on interest paid:

- on foreign-raised funding by Australian banks;
- to foreign banks by Australian branches; and

- on related party borrowings by financial institutions.

The Henry Tax Review

The Henry Tax Review, in its Final Report entitled "Australia's Future Tax System" and released in May 2010, recommended that "financial institutions operating in Australia should generally not be subject to interest withholding tax on interest paid to non-residents." It is noted that the recommendation reflected AFMA's submission to the Henry Tax Review, which stated that "the cost of this reform would be small in the context of the tax system and would be more than offset by the economic benefits it would generate."

The Final Report of the Financial System Inquiry

The Final Report of the Financial System Inquiry echoed these themes, where it observed:

> "(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."

Government Response

In the 2010-11 Federal Budget, the Government announced that, pursuant to the recommendations in both the Johnson Report and the Henry Tax Review, it would phase down the interest withholding tax paid:

- by foreign bank branches to head office to 2.5% from 2013-14 and 0% from 2014-15;
- by other financial institutions/borrowings to 7.5% from 2013-14 and 5% from 2014-15.

On 23 November 2011, the then Assistant Treasurer announced that the phasing down of interest withholding tax would be deferred by one year.

It is noted that the phase-down of interest withholding tax was part of the tax reform package that Australia committed to at the 2010 G-20 summit in Seoul.

Current Government Comments

On 28 August 2013, the then Shadow Treasurer and Shadow Minister for Finance, Deregulation and Debt Reduction issued a media release entitled "Coalition's Responsible Budget Savings." In this media release, the savings that would be made as a consequence of the abolition of the MRRT were announced; these included "discontinuing the phasing down of interest withholding tax on financial institutions." The media release did not articulate the basis for the discontinuance of the phase down from a policy perspective, except for the assumption that the phasing down was part of a spending package funded by the MRRT.

6.1.2 Policy Position

AFMA strongly supports the recommendation in the Johnson Report regarding interest withholding tax for financial institutions, given the benefits that will arise to the broader economy. AFMA believes that a reduction and ultimately elimination of interest withholding tax on interest paid by financial institutions would improve banks' access to cost effective funding from overseas and contain the rise of cost in financial intermediation, which is increasing due to, in part, the increasing regulatory burden.

It is AFMA's view that the discontinuance of the phasing down of interest withholding tax will hinder competition in the banking sector and therefore have an adverse impact on Australian business and borrowers. The discontinuance of the phase down of interest withholding tax would appear contrary to the Government's stated policy objectives of improving banking competition.

It is noted that the tax base for interest withholding tax has been reduced in recent years, both due to an expansion of the operation of the interest withholding tax exemption in Section 128F of the 1936 and the increased number of Double Taxation Treaties concluded with Australia, particularly the US and UK, that offer an interest withholding tax exemption for interest paid to a non-related financial institution.

Recommendation 13: That the phase-down of interest withholding tax for financial institutions again be committed to and implemented.

6.2 Section 128F

Broadly, Section 128F offers an exemption from interest withholding tax for returns paid to non-residents on debentures/debt interests that pass the "public offer test." There are a number of ways in which the test may be satisfied, including offering the interest (including through an intermediary such as a dealer):

- to ten or more unrelated parties that generally carry on business of providing finance or investing in securities, in the course of operating in the financial markets;
- to 100 or more unrelated parties who may be interested in acquiring the debentures/debt interests;
- via an approved stock exchange; or
- via negotiations initiated on an electronic platform routinely used in the financial markets.

Further, the issue of a global bond also satisfies the public offer test.

While there have been recent enhancements to the operation of the Section 128F exemption, such as clarity as to its application with respect to syndicated loan facilities and to Government authorities, which have broadened the ambit of the exemption, operationally it is still difficult to satisfy and would benefit from reform.

In particular, it is difficult to ascertain with certainty as to whether a debt instrument has satisfied the test. This is due, in part, to different roles being conducted by different parties with respect to the offer of the instrument, such as the issuer confirming that the instrument is a "debenture or debt interest" and the dealers being tasked with offering to the requisite number of investors. There are issues with respect to "reverse enquiries" where the terms of the debt interest may differ from that originally offered and also identification and monitoring of any associates of the issuer, which may invalidate the availability of the exemption for all lenders. Adherence to the requirements imposes significant compliance costs and is more onerous that comparable regimes/provisions globally.

Recommendation 14: That a review be conducted as to the appropriateness of the Section 128F exemption in light of initiatives from other jurisdictions to reduce the burden of interest withholding tax.

6.3 Interest Withholding Tax Exemption for Interest Paid To/From CCPs

The final area in relation to interest withholding tax that, in our view, ought to be considered as part of the Tax White Paper process is the application of interest withholding tax to payments of interest (or in the nature of interest) to Central Counterparties (**CCPs**). AFMA, together with the Australian Bankers Association and the Financial Services Council, has previously lodged a submission to Treasury on this issue but we are yet to see a response.

Broadly, this issue arose as a consequence to the G-20's over-the-counter (**OTC**) derivative reforms, which seek to enhance transparency in such transactions by ensuring that they are, to the extent possible, collateralised and cleared through a CCP. This will result in interest flows between market participants and CCPs, which may or may not be located in Australia. Consequently, the requirement to collateralise and clear will give rise to cross-border interest flows that may not have existed without the clearing requirement. Such an outcome would be inconsistent with the treatment of withholding tax in other jurisdictions and give rise to market distorting outcomes. It is noted that, where interest withholding tax is imposed, the market standard is to compel the payer to "gross-up" for the amount of the withholding tax, thereby hindering the competitiveness of Australian market participants and, indeed, Australian-based CCPs.

It was this issue referred to in 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 derivatives need to be collateralised and cleared through a regulated central counterparty (CCP). 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."

This is an issue where the revenue impacts of providing the specific relief would be *de minimis* but would significantly hinder the ability of Australian market participants to

operate in a globally competitive environment, and hence we reiterate that the proposed withholding tax exemption be taken up by Government. More broadly, this issue represents an appropriate example as to where taxation and regulatory outcomes should be aligned, such that imposition of a regulatory outcome does not stymie the competitiveness of Australian enterprises.

Recommendation 15: That an interest withholding tax exemption for interest paid to/from central counterparties be legislated as a matter of urgency.

6.4 More Enduring Reform of Interest Withholding Tax

The comments above in relation to the application of interest withholding tax is written through the lens of the existing architecture of the Australian taxation system and previous Government announcements.

However, given the ambit of the review being conducted, there is an opportunity to evaluate the role of interest withholding tax more holistically, particularly given the willingness of other OECD jurisdictions to expand the range of exemptions or abolish interest withholding tax altogether.

The Discussion Paper acknowledges Australia's status as a small, open economy that is reliant on foreign investment (given persistent current account deficits), in either debt or equity form. Interest withholding tax places an additional cost on, and is an impediment to, overseas funding, either through exacerbating the hurdle rate for foreign investment or by increasing costs to Australian enterprises by requiring the borrower to "gross-up." These impediments exist at a time where the interest withholding tax base is shrinking, due to both expansion of the nature of interests to which Section 128F may apply and also the continuing negotiation of Double Taxation Treaties that include an interest withholding tax exemption.

AFMA notes that, as a comparison, the UK offers a broader range of interest withholding tax exemptions, including:

- All payments made to or by a UK bank or by a UK branch of a foreign bank;
- Payments of interest on a quoted Eurobond; and
- Payments of "short" interest, which is basically payments of interest on loans that will not have more than a 12-month duration.

Broadly, these three provisions provide a tangible example as to many of the issues arising in respect of the application of the interest withholding tax provisions in Australia may be addressed, specifically:

- Enshrining a broad financial institutions exemption that applies to both outbound and inbound financial institutions;
- Adopting a "quoted Eurobond" mechanism to address some of the operational issues associated with complying with the Section 128F exemption; and

- Ensuring that no interest withholding tax applies to transactions routinely conducted in the wholesale financial markets, such as repurchase agreements, securities lending agreements and collateralised derivatives.

There are clear opportunities for the Australian tax legislation to mirror the UK provisions and place Australian businesses that require debt funding from offshore on a competitively level footing. These include:

- Proceeding with the previously announced phase-down of interest withholding tax for financial institutions in a manner consistent with the UK provisions;

- Providing an exemption for bonds lodged with Austraclear; and

- Introducing a short interest exemption – in this regard we note potential synergies with the 12-month requirement for an eligible securities lending agreement under Section 26BC of the 1936 Act.

Ultimately, from a policy perspective, Australia should implement reforms to the interest withholding tax measures that broadly exempt participants in the financial markets, so as to be aligned with comparable jurisdictions.

Recommendation 16: That more enduring reform of the application of interest withholding tax and the appropriate exemptions be considered.

7. Export of Financial Services

The Discussion Paper notes that "the export of financial services is low by international standards. The removal of tax obstacles and greater clarity on the tax treatment of foreign investors could strengthen Australia's international competitiveness in this area." AFMA agrees with this sentiment and has set out below particular taxation measures/issues that a relevant to our members, clarity in relation to which would enhance Australia's ability to export financial services.

7.1 Offshore Banking Unit Regime

The Offshore Banking Unit (**OBU**) regime is designed to provide tax incentives for highly mobile financial sector activities to be undertaken in Australia. These include financial intermediation between borrowers and lenders and providing financial services to non-resident investors investing outside of Australia. The concessions provided are a 10% corporate tax rate and an interest withholding tax exemption for eligible borrowings.

There are a number of aspects of the operation of the OBU regime that require clarification so as to ensure that the regime discharges its policy objectives in an optimal fashion and is competitive relative to similar regimes in the region. AFMA has recently consulted with the Government in relation to reforms to the regime, which have resulted in proposed legislation which, at the time of writing, had been introduced into Parliament. These reforms will, amongst other things, enhance the ability of Australian personnel to manage both Australian and offshore assets on behalf of a non-resident investor. However, the reforms will fall short of allowing all services, such as custodial and settlement services, relevant to the life-cycle of a financial transaction to be conducted in Australia and hence the regime will continue to fall short of its stated policy objectives.

More broadly, AFMA has continued to advocate for the legislation underpinning the OBU regime to adopt a more principles based approach, particularly in the determination of what is an "eligible" activity. We maintain that the increasingly uncompetitive nature of the OBU regime 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 drafting the law. Importing readily understood concepts, such as the Division 230 definition of "financial arrangement" into the OBU provisions, would assist in future proofing the regime and ensuring it continues to be competitive.

Similarly, there are a number of aspects of the regime, particularly the requirement to keep separate pools of funds between an OBU and the remainder of the institution, which impose considerable red-tape and expense in setting up and administering an OBU. Such inefficiencies are at odds with the Government's current deregulation agenda and hinder the ability of the regime to attract new participants and grow Australia's financial service export capability.

Recommendation 17: That reform to modernise the Offshore Banking Unit regime be continued such that it enhances Australia's financial service exports.

7.2 Alignment of Free Trade Agreements to Tax Treaties

AFMA has acknowledged the Government's recent commitment to concluding free trade agreements with other jurisdictions in the region, which, *prima facie*, enhance Australia's capacity to export financial services. However, our view is that this process needs to be co-ordinated with Australia's network of Double Taxation Agreements, which serve to clarify and allocate taxing rights between jurisdictions. AFMA has previously highlighted instances where the take-up of opportunities under a free trade agreement has been undermined by either uncertainty within an existing Double Taxation Agreement or the failure to update the Double Taxation Agreement such that it is contemporaneous with other jurisdictions.

Recommendation 18: That the co-ordination of Free Trade Agreements with Double Taxation Treaties be integrated via a formal and cross-departmental process.

8. Losses

To what extent does the tax treatment of losses discourage risk-taking and innovation and hinder business restructuring? Would alternative approaches be preferable and, if so, why?

AFMA members agree with the comments in the Discussion Paper regarding the extent to which the current integrity rules for the recoupment of carried forward company losses, namely the continuity of ownership (**COT**) test and the same business test (**SBT**), hinder legitimate restructuring and innovation, through precluding changes of ownership and pursuing new business opportunities that may cause a failure of the SBT. Indeed, it is counter-intuitive that an entity that has incurred tax losses is precluded from changing its business structure so as to allow it to become profitable by virtue of the threat of failing the SBT.

It is noted that the integrity rules were formulated, and have not been substantially amended, since the advent of the Tax Consolidation Regime. In the consolidation context, an entity with carried-forward losses that is acquired and brought into a tax consolidated group will need to satisfy both COT and SBT on entry and then also have the utilisation of the losses by the consolidated group spread by the "available fraction."

AFMA agrees with the broad conclusions of the Business Tax Working Group that the current integrity rules, and the SBT in particular, are inconsistent with the modern, dynamic business environment and lock businesses into inefficient structures. There may be a case for the removal of the SBT and, where COT is failed and the target entity is brought into a tax consolidated group then the available fraction becomes the appropriate method of spreading losses.

Further, we note that in a genuine commercial transaction, the available fraction rules that apply when losses are brought into a consolidated group are too rigid and should be sufficiently flexible to acknowledge where the loss-making business becomes profitable.

Accordingly, we would support the recommendation of the Business Tax Working Group of a further review of the company loss recoupment provisions, with a particular focus on the continuing utility of the SBT.

Recommendation 19: That a review be undertaken of the company loss recoupment provisions in a manner as recommended by the Business Tax Working Group.

9. GST and Indirect Taxes

To what extent are the settings (that is, the rate, the base and administration) for the GST appropriate. What changes, if any, could be made to these settings to make a better tax system to deliver taxes that are lower, simpler, fairer?

AFMA's response in relation to the current GST settings pertains primarily to the area of financial supplies, which are routinely made by AFMA's members. In this regard, we note the comment in the Discussion Paper that "(f)inancial supplies, that is, the borrowing and lending of money, were input-taxed due to the difficulty of identifying and measuring their value, which is often not explicit. While applying GST to financial supplies would introduce significant complexity, the current approach brings its own complexities."

AFMA was heavily involved in the consultation regarding the application of GST to financial supplies at the time of commencement of the GST in 2000. In short, we believe the current approach adopted in Australia, that is, the treatment of financial supplies as input-taxed and the existence of the Reduced Input Tax Credit (**RITC**) regime, represents global best-practice and there is not a compelling basis for amendment of the treatment of financial supplies.

The current structure of the GST regime, as it applies to financial supplies, is the result of a significant amount of work undertaken during and since the commencement of GST by industry, Treasury and the ATO. The outcome is a robust foundation whereby the application of the GST provisions is sufficiently clear so as to allow for compliance at an acceptable cost to business. Accordingly, while there are some acknowledged inefficiencies with the present system that are inherent to the application of indirect taxes to financial supplies, the costs associated with changes to the current approach cannot be underestimated. There would need to be a compelling case for any changes and given how the Australian regime operates vis-à-vis comparable regimes in other jurisdictions, it is very unlikely that such a case could be made.

9.1 GST Treatment of Financial Supplies

The Australian GST regime, like many of its peer regimes globally, operates on an "invoice-credit" model, whereby the GST is payable on consideration, as evidenced in an invoice and the maker of the supply is entitled to a credit for any GST levied on inputs with respect to the making of the supply.

A fundamental aspect of the regime is that the consideration for the supply is identifiable on a transaction-by-transaction basis. In the context of financial supplies, the consideration received is generally not explicit, but forms part of a margin. Hence it is impractical to determine the consideration applicable to a financial supply. This point was well-made by the Henry Tax Review, which noted, with respect to the GST regime:

> "Taxing financial services under this system is complex and inefficient, mainly because it is difficult to measure the value of the services provided in individual financial services transactions."

As a result of the complexity, there is no jurisdiction within the OECD that currently seeks to treat financial supplies as taxable within the invoice/credit model. As such, Australia's treatment of financial supplies from a GST perspective should not be viewed as a concession, but rather as an acknowledgement of the impracticalities associated with determining the consideration to which GST applies.

Moreover, it is important to note that input taxation of financial supplies is a punitive outcome for business transactions, which under GST policy principles should not be subject to any net GST (i.e. any GST paid on inputs should be fully rebated). This is in direct contrast to the position for consumers under input taxation.

It is noted that Australia's definition of "financial supply" for GST purposes is narrower than other comparable jurisdictions. This, coupled with the RITC regime, reduces the inefficiencies inherent to the input-taxed treatment of financial services, such as the cascading burden of the tax through the denial of credits and the bias towards insourcing services.

9.2 The RITC Regime

The introduction of the reduced credit acquisition regime was a critical policy innovation that has both served the economy well and received endorsement from the OECD. The policy rationale for the regime, that is, to address the insourcing bias for those financial services that may be treated as taxable, has promoted simplicity and reduced complexity for a number of Australian businesses. Further, it has allowed financial institutions to make outsourcing decisions based on economic efficiency and not tax treatment. This has enhanced banking competition by placing larger institutions on a competitively neutral playing field with smaller institutions, which would generally have a limited capacity to insource services.

It is noted that, for most services, the RITC rate is 75%. It is AFMA's view that this rate has achieved the Government's objective of ensuring that outsourcing decisions are based on economic factors, as opposed to taxation considerations, and that places Australia's GST regime on a globally competitive footing. This becomes increasingly important due to enhanced capital mobility and therefore the necessity that Australia's tax settings do not impose disincentives for investment. The current rate is below that which was initially requested by industry of 85%.

One of the more concerning developments with respect to the GST regime, and in relation to RITCs specifically, was the introduction in 2012 of a reduced RITC rate of 55% for "trustee services." This development has significantly increased compliance costs without resulting in a material change to Government revenue. AFMA would caution against the imposition of different RITC rates for different supplies in the future.

9.3 International Comparisons

As noted by the Henry Tax Review, other jurisdictions have sought to apply different GST treatments to financial supplies. In particular, Singapore, while treating financial supplies as input-taxed, offers credits to suppliers similar to Australia's RITC regime, but over a broader range of supplies. New Zealand's regime is even broader, as it treats all business-

to-business financial supplies as GST-free, thereby allowing for full recovery of input tax credits and removing the cascading effect arising from input taxation.

Given it remains a stated policy objective of the Government to enhance Australia's standing as a financial centre, it is paramount that the GST regime operates in a manner not inconsistent with regional and global peers, particularly in an environment of enhanced capital mobility. Hence, AFMA would strongly caution against widespread amendment to the GST treatment of financial supplies from an international competitiveness perspective that would seek financial supplies as taxable.

10. Financial Transactions Tax

The Discussion Paper acknowledges the existence in other jurisdictions of "financial transaction taxes," (**FTT**) which are broadly taxations imposed on the consideration payable on transfer of financial instruments, such as stocks, bonds and derivatives. Recently, the introduction of a financial transactions tax in Australia has been mooted in various circles.

AFMA does not support the introduction of an FTT in Australia. An Australian FTT would, in our view, impose an unwarranted cost on the community as a whole, introduce inefficiencies into the economy and put Australia at a competitive disadvantage in the Asian region. In particular, an FTT, however struck, would materially reduce the value of traded investments (such as shares) which would affect the large, and ever-increasing, number of Australian individuals and superannuation entities that hold such instruments. An FTT, by taxing transactions as opposed to profit, necessarily restricts liquidity in the capital markets at a time when enhanced liquidity and transparency is being promoted by regulators globally.

In addition, an FTT in Australia would conflict with a number of existing Government policies, including:

Bank competition – An FTT would reduce the ability of the corporate bond and equity market financing channels to compete with banks. It would also disadvantage business models that rely on wholesale market funding, such as regional banks and some credit unions that would seek to use the securitisation market.

Financial stability - Based on the available evidence, there is significant concern a financial transactions tax would be counterproductive to financial stability by reducing the liquidity of financial markets.

Bank liquidity - Another area of policy conflict is a reduction in the intrinsic liquidity value of actively traded securities. This would be counterproductive towards the Basel III liquidity reforms that Australia and other countries are currently implementing.

It is noted that the Henry Tax Review evaluated, and soundly rejected, the economic basis for an FTT. The Review noted:

> "Transaction taxes…are generally inefficient because the tax rate rises according to how often an asset changes hands, rather than any underlying economic value. There is no 'economic base' for transaction taxes… There is no necessary correlation between trading volume and the creation of systemic risk. The tax would apply indiscriminately to transactions that are socially useful – including those that contribute to financial system stability – and those that are costly.
>
> "In fact, transaction taxes could potentially reduce financial stability. They would reduce market liquidity, which could lead to prices becoming more volatile and more prone to misalignment. They would also impede hedging activity, which can involve a large volume of transactions to disperse risk...

> "It would be difficult to prevent activity shifting to unregulated sectors or jurisdictions…"

These concerns were materialized in practice in recent jurisdictions that sought to introduce an FTT. In 1987, the Swedish Government introduced an FTT on a wide range of securities. The revenue that was raised by the tax fell well short of Budget expectations, with approximately 3% of the expected revenue raised, largely due to financial market activity being relocated to other jurisdictions, thereby reducing liquidity (and hence the transactions to which the tax applied) and also capital gains tax receipts.

More recently, eleven jurisdictions within the European Union have sought to implement an FTT. As not all member states agreed with the proposed adoption of an FTT, in October 2012 the European Commission proposed that enhanced co-operation could allow for these jurisdictions to implement the FTT. However, as at May 2015, no agreement has been reached by the participating jurisdictions as to the ambit of the tax, with the latest proposal being that it is to apply to equities and "some" derivatives, let alone how to share the revenues arising from the tax. Participating jurisdictions, such as the German Finance Minister Wolfgang Schaeuble, are on record as stating that the revenue generated from the tax would be "very modest."

In an Australian context, proponents of an FTT have suggested that it apply only to high-frequency trading and not to other transactions. This aspect of the proposal leads to some conclusions:

- Such a proposal implicitly recognises that that taxing other forms of financial transactions, such as those undertaken by retail investors and superannuation funds, is sub-optimal, on the basis that it raises the cost of financial intermediation and these costs are ultimately passed through the broader economy; and

- Any FTT imposed purely on high-frequency trading will significantly stymie such activity in Australia. High frequency trading relies, at least in part, on thin margins and the imposition of an FTT would cause the bid/offer spread on listed instruments to increase significantly. Consequently, any revenue raised would be *de minimis.*

Ultimately, AFMA's view is that taxing financial transactions is at odds with the thrust of recent tax reform efforts, which are rightly aimed at reducing or eliminating inefficient taxes, as well as the bi-partisan policy objective of promoting Australia as a regional and international financial centre.