AUSTRALIAN BANKERS' ASSOCIATION INC.

David Bell
Chief Executive Officer

Level 3, 56 Pitt Street
Sydney NSW 2000
Telephone: (02) 8298 0401
Facsimile: (02) 8298 0447

9 July 2007

The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

Attention: Peter Hallahan

Dear Mr Hallahan,

Tax Laws Amendment (2007 Measures No. 4) Bill 2007

Thank you for providing the Australian Bankers' Association Inc (**ABA**) with the opportunity to make a submission regarding the proposed amendments to the taxation law contained in *Tax Laws Amendment (2007 Measures No. 4) Bill* 2007 (**TLAB No.4**).

Whilst the ABA strongly welcomes the abolition of foreign loss and foreign tax credit quarantining and the simplification to the current law proposed under TLAB No.4, the ABA believes the amendments as they impact Offshore Banking Units is in conflict with the policy intent behind the Offshore Banking regime, instead weakening Australia's attractiveness as a financial centre. In addition, the current proposed amendments create inconsistencies between the way double taxation is relieved with respect to Offshore Banking (**OB**) income and non-OB income.

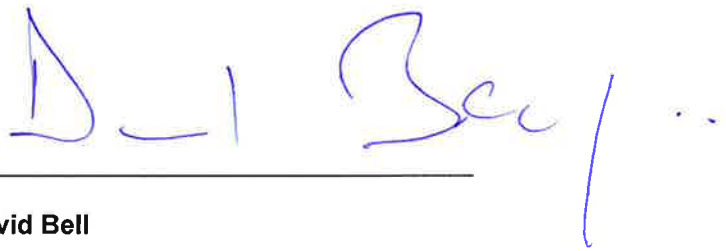
Please find attached the ABA's submission in relation to the OB provisions contained in TLAB No.4. These can be summarised as:

- The calculation of the foreign tax offset limit has been drafted to allow greater averaging capacity to taxpayers, minimising the foreign income tax that goes unrelieved. As a result the carry forward of excess foreign tax credits will no longer be available. This averaging capacity should also be extended to OB income, but in such a way that the Offshore Banking Unit (**OBU**) is not able to use additional foreign tax to shelter non-OB foreign source income;

- The transitional provisions in relation to the utilisation of carried forward OB foreign tax credits needs to be amended on a similar basis, to provide consistency between OB and non-OB income, but in such a way that the Offshore Banking Unit (**OBU**) is not able to use carried forward OB foreign tax credits to shelter non-OB foreign source income.
- Clarification is required in the drafting of the foreign tax offset limit to ensure that the legislation is consistent with the policy intent behind the treatment of debt deductions as articulated in the *Explanatory Memorandum* to TLAB No. 4 (**the EM**).
- Amendment is required to the anti-avoidance provisions which are currently drafted very widely, potentially applying to normal financing arrangements that include a standard gross-up clause. As drafted, these provisions put Australian lenders at a commercial disadvantage when participating in genuine overseas financing arrangements as they effectively increase the cost for foreign borrowers of obtaining finance from Australian lenders.

If you have any queries regarding the matters canvassed in this submission, please do not hesitate to contact Tony Burke at the ABA on (02) 8298-0409.

Yours sincerely



David Bell

Australian Bankers' Association submission to

Senate Standing Committee on Economics

In relation to *Tax Laws Amendment (2007 Measures No. 4) Bill* 2007

1. Background to the introduction of the offshore banking unit regime

The Federal Government introduced the offshore banking unit (OBU) regime to promote Australia as an internationally competitive offshore banking centre. The OBU measures were part of a package of legislative reforms aimed at making Australia a more attractive regional financial centre by building on Australia's existing advantages to ensure its participation in the increasing global trade in financial services. The OBU regime was broadened further under *Taxation Laws Amendment Act (No. 2) 1999,* which was stated as being an important development in the Government's policy to enhance Australia's credentials as a world financial centre and to promote Australia on the world stage.

The legislative changes extended both the range of entities eligible to be classed as an OBU and the range of activities that will be classed as eligible offshore banking activities. The changes were brought about in an attempt to increase the attractiveness of the OBU regime, by reducing the compliance burden and widening the concessions available, thus seeking to encourage financial institutions and other entities to expand their offshore banking activities and generate larger revenues from such operations.

Australian Banks have accordingly responded to the incentives offered under the OBU regime, expanding their OB activities in recent times. However, this expansion has been restricted as a result of limitations arising from the drafting of the current provisions. The proposals in TLAB No.4 with respect to the OBU will provide further restrictions to the expansion of OB activities, precluding the full use of the OBU provisions by Australian Banks, both in the way that the OBU is currently used and is intended to be used in the future. Where less than full advantage of the initiatives offered by the OBU regime is taken, this does not aid the Government in achieving its goal of facilitating the growth of Australia as a viable offshore banking centre and in the present case may have the opposite effect.

2. Calculation of the foreign income tax offset

Under TLAB No.4 the foreign income tax offset limit applies to cap the foreign tax offset by reference to the amount of Australian tax payable on double-taxed amounts and other assessable income amounts that do not have an Australian source (s770-75). The EM to TLAB no.4 provides at para 1.20 that this will allow

a greater averaging capacity and is therefore used as a justification for the removal of the carry-forward of excess foreign tax credits:

> *"Rather, a taxpayer can combine all assessable foreign income amounts when working out a tax offset entitlement, allowing the taxpayer a greater averaging capacity than under the old foreign tax credit rules. This greater averaging capacity will minimise the amount of foreign income tax that goes unrelieved. Consequently, the mechanism allowing the carry-forward of excess foreign income tax will be removed."*

and at para 1.141

> *"...allows the tax payer a greater averaging capacity, in that all high foreign taxed amounts are amalgamated with low foreign taxed amounts."*

However, the increased averaging capacity is denied with respect to OB income by virtue of existing ss121EJ (1) and s121EJ (2) and proposed section s121EJ. The EM acknowledges this denial at para 1.141 although no explanation for the policy underlying this denial is provided.

Whilst it is not being suggested that the removal of foreign tax credit quarantining should allow the OBU to use additional foreign tax to shelter other types of low-taxed foreign source income, it is also not correct to impose a higher hurdle on the OBU in calculating the foreign tax offset limit than imposed on any other type of income. This higher hurdle is especially at odds with the policy objective underlying the introduction of the OBU provisions to enhance Australia's credentials as a world financial centre.

Accordingly the following amendments to TLAB No.4 are required:

(1) proposed s121EJ should be amended to:

[Australian source] For the purposes of this Act, other than s121EG(3A) and s770-75(4) of the Income Tax Assessment Act 1997, income of an OBU that is derived from OB activities of the OBU is taken to be derived from a source in Australia.

(2) proposed s121EG(3A) should be amended to:

(a) Subject to section 121EH, this Act applies to an OBU as if the only amount of foreign income tax (within the meaning of the Income Tax Assessment Act 1997) the OBU paid in respect of an amount of assessable OB income is the greater of:

(i) $1,000; and

(ii) this amount:

(a) the amount of income tax payable by you for the income year; less

(b) the amount of income tax that would be payable by you for the income year if the assumptions in paragraph (c) were made.

Note 1: If you do not intend to claim a foreign income tax offset of more than $1,000 for the year, you do not need to work out the amount under paragraph (ii).

Note 2: The amount of the offset limit might be increased under section 770-80.

(b) For the purposes of paragraph (a)(ii), work out the amount of income tax payable by you, or that would be payable by you, disregarding any *tax offsets.

(c) Assume that:

(i) your assessable income did not include:

(a) so much of any amount included in your assessable income as represents an amount in respect of which you paid *foreign income tax that counts towards the *tax offset for the year; and

(b) any other amounts of *ordinary income or *statutory income from a source other than an *Australian source; and

(ii) you were not entitled to any deductions that:

(a) are *debt deductions that are attributable to an *overseas permanent establishment of yours; or

(b) are other deductions (excluding debt deductions) that are reasonably related to income covered by sub-paragraph (i) for that year.

The above amendment will ensure that the OBU is not able to use additional foreign tax to shelter other types of low-taxed foreign source income whilst still allowing the same increased averaging capacity for OB income as it allowed to all other types of income. This is especially important given the removal of the carry forward of excess foreign tax credits.

The need for this change is particularly highlighted in Example 1.7 included in the EM where Big Bank Limited's OBU earns net income of A$77,500 of which it is subject to foreign tax of A$21,000, that is an effective tax rate of 27.1%. Given that foreign tax has already been suffered well in excess of the 10% tax rate that the OBU provisions provide for eligible OB income, additional Australian tax should not be suffered. However, the OB provisions in TLAB No.4 as currently drafted provide for further Australian tax to be payable of $750, increasing the effective tax burden to 28.1%.

This outcome is clearly inconsistent with both the operation of proposed Division 770 for all non-OB income and the policy underlying the OBU provisions. Instead of enhancing the attractiveness of Australia as a financial centre, it does the opposite creating a disincentive for Australian banks to utilise the OBU provisions rather than similar offshore banking concessions provided in other jurisdictions.

3. Transitional Measures

The proposed 2/3 reduction of carried forward foreign tax credits relating to the OB class as part of the transitional measures (proposed item 2 in the table in s770-220(3) of the *Income Tax (Transitional Provisions) Act* 1997 is explained in the EM at para 1.307 of the EM as necessary to ensure that excess foreign tax credits relating to assessable OB income are not used to shelter other low foreign taxed income from Australian tax.

However, given the above changes to the way in which the foreign tax offset limit is calculated with respect to OB income, the transitional measures need similar change to ensure that the utilisation of pre-commencement excess foreign income tax will be subject to the limits calculated under the new foreign offset rules, consistent with the principles articulated in para 1.28 of the EM.

This can be achieved by amending proposed item 2 in the table in s770-220(3) to:

> *The amount of those excess foreign tax credits reduced in accordance with s121EG(3A)*

4. Clarification required to 770-75(4)(b)(ii)

In calculating the foreign income tax offset limit, proposed s770-75(4)(b)(i) includes an assumption that you are not entitled to debt deductions attributable to your overseas permanent establishment and s770-75(4)(b)(ii) includes an assumption that you are not entitled to any other deductions that are reasonably related to income subject to foreign tax and income from a source other than an Australian source.

The EM at paras 1.143 to 1.148 makes it clear that debt deductions are not disregarded for the purposes of the second element of the cap calculation (except to the extent that they are attributable to your overseas permanent establishment) consistent with the existing treatment and the changes made to the thin capitalisation provisions in 2001. "*This preserves the existing treatment of debt deductions as falling outside the cap calculation, consistent with the thin capitalisation changes referred to above.*"[1]

[1] At para 1.148 of the EM

Proposed s770-75(4)(b)(ii) needs to be amended to make this clear as follows:

> *"are other deductions (other than any relevant debt deductions) that are reasonably related to income covered by paragraph (a) for that year."*

This clarification is consistent with the wording in the definition of "net foreign income" at paragraph (b) included in current s160AF(8) of the Act and the policy objective articulated in the EM.

5. Section 770-140 Anti-avoidance rule

Proposed s770-140(b) would deny the benefits of the foreign income tax offset to the extent that the taxpayer or any other entity become entitled to any other benefits worked out by reference to the amount of the foreign income tax.

Para 1.124 of the EM suggests that the provision is intended to deny foreign tax offset benefits that may arise from the exploitation of arbitrage opportunities resulting from mismatches in debt and equity classification and the different status granted to foreign hybrid entities.

However, we are concerned that the ambit of the paragraph is rather general and wide and may affect normal financing transactions. It is normal for cross border financing to include a "gross up" clause to ensure that the lenders are not disadvantaged by the deduction of interest withholding tax by the resident country of the borrower. The amount of the gross up is the amount of tax deduction required to be withheld by the payer. It is common internationally for lending agreements to include a "tax refund" clause whereby the lender would refund to the borrower the amount of the gross up if the lender is able to claim a tax offset in respect of the amount of withholding tax.

Prima facie, the new provision could deny foreign tax offset to Australian financiers that are subject to such a "gross up" arrangement. This will result in higher interest costs for foreign borrowers obtaining finance from Australian lenders. This may potentially affect the ability of Australian financiers to participate in overseas financing transactions.

We recommend that the provision should be amended to ensure that genuine commercial transactions will not be affected.