Senate Select Committee on Superannuation and Financial Services

Main Inquiry
Reference (b)

Submission No. 18 (Supplementary to Submission No. 2)

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29 June 2000

Ms Sue Morton
Secretary
Senate Select Committee on Superannuation
and Financial Services
Parliament House
Canberra
ACT 2600

Dear Ms Morton

I refer to your letter of 26 May last to Mr Robert Webster, Executive Director of IBSA, concerning the provision of additional material in connection with his evidence to the Committee on 16 May.

On Mr Webster's behalf, I have enclosed:

- A copy of IBSA's submission to the Treasurer about the potential impact of the Ralph Review of Business Tax recommendations on foreign banks (attachment 1);
- A set of comments on the practical difficulties that member banks encounter with the OBU regime (attachment2).

Please contact me if you have any queries.

Yours sincerely

David Lynch
Director of Policy

Attachment 2

Offshore Banking Units – IBSA Comments

Our comments below provide information on the character of operational problems and uncertainty associated with the existing offshore banking unit (OBU) regime, based on reports from IBSA's member banks. These naturally suggest areas that might be amended to improve the attractiveness of the regime. For example:

- To properly reflect the commercial reality of OBU operations in the way they are taxed, the rules for apportioning expenses must be revised to unambiguously accord with economic principles;
- To reduce compliance costs and complexity, all OBU transactions should be GST-free and gold trading with non-offshore persons in A$ should be permitted, and
- To reduce uncertainty, aspects of the existing rules like the terms under which access will be granted to the regime need to be developed further and the future thin capitalisation rules need to be decided.

More generally, member banks have frequently commented on the complexity of the OBU legislation and difficulty in interpreting it. The OBU regime needs to be better presented and marketed.

There is evidence to suggest that some member banks are using the OBU regime more widely and that others are closely considering new OBU operations. This is for a variety of reasons, including recent enhancements to the OBU regime, greater awareness of the commercial benefits to conducting business in Australia since the Government launched its global financial centre initiative and Australia's resilience during the Asian financial crisis. This provides fertile ground to build on the benefits that would accrue from further improvements, without which the regime will not achieve its potential.

We note that our comments here are directed at difficulties with the detail of the existing regime and do not comprise a comprehensive list of measures that should be undertaken to improve the regime. Taking a broader policy view, other improvements should be considered, like:

- Removal of dividend withholding tax from OBU profit repatriations;
- Widening the range of companies eligible for OBU status to include corporate treasuries;
- Widening the range of activities, for example, to include back office processing, and
- Improving flexibility for the authorities to update the OBU regime, address operational and administrative difficulties that arise and maintain its international competitiveness.

These and other issues should be considered as part of a broader policy review, which is beyond the scope of this exercise.

OBU Expense Allocation

Where a company conducts both OBU and non-OBU activities (which we shall call the 'domestic banking unit' or DBU), it is necessary to allocate expenses between these two lines of business. Unfortunately, the rules in the legislation for allocating expenses to an OBU are deficient in a number of respects (ref section 121EF of the *Income Tax Assessment Act 1936*).

The prescriptive approach to OBU expense allocation that presently applies is indiscriminate and does not reasonably reflect the commercial or economic cost of OBU transactions. The prescribed allocation formula proportionately divides overhead expenses between the OBU and the DBU depending on their relative contribution to a bank's total assessable income. Because the general business mix of banks typically varies considerably with that conducted through their OBUs, this gives rise to cost allocations which are not economically meaningful.

In addition, an OBU's cost base is uncertain until after year-end, when the bank's total assessable income and allowable deductions are known. This introduces unnecessary uncertainty for OBUs that must compete on price. Together with the anomalous outcome from the expense allocation formula, this introduces a cost variable that has no commercial basis and increases pricing risk.

Current Rules for OBU Expense Allocation

Expenses that relate exclusively to OB income (e.g. the salary of a dealer employed full-time by the OBU) are allocated directly to the OBU. This treatment is straightforward and does not create a difficulty.

However, overhead costs that are shared by the OBU with the DBU must be apportioned according to a formula based on a ratio of assessable OB income to total assessable income.

$$\text{General OB deduction} = \text{Deduction} \times \frac{\text{Adjustable assessable OB income}}{\text{Adjusted total assessable income}}$$

Where

"Adjusted assessable OB income" is gross assessable OB income less interest exclusively incurred in deriving that income.

"Adjusted total assessable income" is the entity's total gross assessable income less interest exclusively incurred in deriving that income.

This formula is not appropriate for allocating overhead expenses and gives a somewhat arbitrary outcome, because it does not reflect the economic cost of operating the OBU.

For example, if the OBU earns proportionately more fee income (and say proportionately less high volume low margin type trading income) than the DBU, then it will typically bear a disproportionate part of the overheads of the bank. The OBU's income for tax purposes will then be understated for tax purposes and the DB's income will be overstated, giving rise to a higher average tax rate.

Progress Towards Simplification

The Prime Minister's "Investing for Growth" initiative at the end of 1997 included a commitment to consultation on the introduction of simpler expense allocation rules. There followed constructive discussion with the Tax Office on a more helpful interpretation of the current law, though the feeling amongst members is that legislative change will ultimately be necessary if a secure economic expense allocation is to be available to OBUs. Tax reform has now diverted attention to other, now more pressing, indirect tax and general business income tax issues.

Banks favour an approach to OBU expense allocation that would prescribe a broad principle that expense allocation should reflect the resources used in producing the income booked in the OBU, with banks required to produce appropriate records on audit.

The apportionment of expenses between a company's OBU and DBU should be based upon a reasonable allocation of expenses having regard to the cost of deriving those income streams. In this regard, the line of business full absorption expense that is used for internal accounting purposes should be an acceptable means to establish the expense to be allocated to the OBU. Other methods that produce an OBU expense allocation that reasonably reflect the economic cost of supporting OBU activities should be acceptable.

Apportionable Expenses

Another concern, that is relatively minor, is that the OBU expense allocation formula requires an iterative calculation. In addition to exclusive OB and general OB deductions, there is a third category of expense allowable for deduction, called apportionable deductions: This refers to amounts, like charitable donations, that do not have any connection with the production of assessable income. An apportionable OB deduction must be determined in accordance with a formula that includes the 'OBU's taxable income', though this figure cannot be determined until the amount of the apportionable OB deduction is known.

GST Treatment of OBU's

The GST legislation does not deem offshore banking transactions to be GST-free, which increases both the complexity of the tax regime and the associated tax compliance costs for OBUs.

Most OBU transactions are conducted with non-residents and, hence, would be GST-free. However, some transactions may involve dealings with residents (e.g. dealings with other OBUs or non-AUD foreign currency transactions) and these would be either input taxed or taxable under the GST.[1] For example, if an OBU takes on a large foreign exposure through a dealing with a non-resident and divests some of this risk by selling it to another OBU, then the latter transaction would not be GST-free, since the other OBU is 'in Australia'.

[1] Dealings with residents are strictly limited by the OBU legislation.

The consequent need to separate OBU transactions into three categories (GST-free, taxable and input taxed) instead of one (GST-free) creates additional compliance costs for OBUs, without any material benefit to Government revenue. The problem is further exacerbated by the fact that the GST rules for allocating expenses to the OBU are different to those in the OBU legislation discussed above, so anticipated synergies in tax compliance do not exist. The complications associated with tracking transactions according to different rules are a disincentive to the OBU.

The GST treatment of OBU's is counterproductive to the Government's effort to attract global financial services business to Australia. Apart from tax compliance cost issues, it sends a confusing signal to potential entrants about the Government's ability to implement pragmatic solutions to their problems.

OBU transactions should be deemed to be GST-free. This would reduce compliance costs for OBUs without a material affect on Government revenue. It would also support the development of international business in Australia.

Thin Capitalisation

The Review of Business Taxation recommended the introduction of new thin capitalisation rules based on an entity's gearing ratio rather than on borrowing from related parties. There are to be special rules for financial institutions;[2]

Financial institutions subject to capital adequacy rules

(a) That the safe harbour gearing levels for authorised banks and other financial institutions that are subject to capital adequacy rules be based on the capital levels reported for regulatory purposes.

Financial institutions not subject to capital adequacy rules

(b) That financial institutions not subject to capital adequacy rules be subject to:

(i) the safe harbour gearing level of 3:1 — but with an 'on-lending' rule disregarding debt, to the extent that it is on-lent, in the thin capitalisation calculations; and

(ii) a maximum gearing limit of 20:1 — beyond which interest deductions will be denied.

However, the manner in which these rules will apply to OBU's has yet to be stated, which creates uncertainty. For example, foreign branch banks do not incur a notional equity charge for their OBU assets under the current income tax regime, but their treatment under the new rules is unclear. The Association has raised this matter with the relevant Government officials and is awaiting a response.

[2] Recommendation 22.4 of the Review of Business Taxation Report, *A New Tax System Redesigned*, AGPS

Other Issues

Facilitating New Products

The OBU provisions are quite prescriptive in some areas and do not readily facilitate the emergence of new products. For example, the range of eligible activities was extended to include trading in base metals, but it does not include base metal derivatives. Members have also suggested that trading in coal be included amongst eligible OB activities. Rather than amending the regime on a piecemeal basis to address these and other issues, it would be better to establish a broad policy position in law; for example, that OBUs can deal in commodities and rights in respect of them.

Interaction with Branch Bank Provisions

Member banks have recently questioned the interaction of the Income Tax Assessment Act 1936 Part IIIB provisions for the taxation of foreign branch banks and the OBU tax provisions. In particular, it appears that interest payments by a foreign branch bank OBU to an offshore branch are subject to the LIBOR restriction on the maximum amount of interest deductible in section 160ZZZA of Part IIIB. A requirement to adhere to the LIBOR limit would be a nuisance from a compliance perspective, rather than a revenue issue.

Gold Trading in A$

The "Investing for Growth" regional financial centre initiative in December 1997 included a measure to permit OBU "trading with any person in gold". This was warmly welcomed by the industry. However, where a transaction is with a non-offshore person, the amount payable under the contract must not be in Australian dollars. This restriction is not warranted from a tax revenue perspective, given the policy principle adopted, and creates inefficiency by essentially bifurcating a single gold transaction in Australian dollars into two contracts and requiring the operation of two gold books within a bank rather than one. This is an administrative disincentive to banks that wish to base a global operation in Australia.

Use of the Treasurer's Determination

The Treasurer has discretion under subsection 128AE(2)(f) of the *Income Tax Assessment Act 1936* to determine, in accordance with specified guidelines, that the company is an OBU. This is another "Investing for Growth" initiative. The Department of Treasury and the Tax Office consulted with industry on the form of the guidelines and a set of guidelines was gazetted in September 1999. The guidelines provide adequate flexibility to appropriately assess applicants in terms of their suitability for an OBU.

However, at this point in time, it is not clear what capital, employment and other requirements the Tax Office might expect of an overseas applicant that does not have an operation already in Australia. The Association is currently exploring this issue with the Tax Office, as it is of interest to institutions that are considering locating business in Australia.

Thick Capitalisation

A deemed interest penalty is levied on equity funding provided to an OBU by its resident owner. The owner is deemed to have received interest income at 2 per cent above the 90 day bank bill rate on 90 per cent of the funds paid to the OBU by way of subscription for shares. The aim of these provisions is to remove the risk of Australian incorporated entities obtaining a 33 per cent interest deduction on the funds allocated as equity to the OBU subsidiary, whilst the OBU subsidiary pays tax on income generated by those funds at 10 per cent.

The policy rationale for this is accepted, however, the current deeming rate provisions operate in a peculiar manner that is hard to understand. The lower is the market rate of interest for bank bills, the higher is the penalty and at high interest rates the penalty eventually becomes an award.

bank bill rate (%)	**deemed rate (%)**	**penalty (%)**
5.0	6.3	1.3
10.0	10.8	0.8
15.0	15.3	0.3
20.0	19.8	-0.2

Changes to the 'thick capitalisation' provisions were announced in the December *Investing for Growth* statement, but they did not eventuate.

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24 December 1999

The Hon. Peter Costello MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Mr Costello

Review of Business Taxation – Foreign Bank Issues

The Government's tax reform program is proceeding at an impressive pace and should produce significant benefits for Australia, not least by enhancing the international competitiveness of the economy. An important aspect of tax reform is the treatment of foreign entities operating in Australia. Foreign-owned banks inject essential competition into our financial markets and are the cornerstone of the global financial centre. In this regard, there are a number of important tax reform issues specific to foreign banks that I would like to bring to your attention.

Our concerns are presented in the attachment under the following headings:

1. Consolidation
2. Thin capitalisation
3. Proposed withholding arrangements
4. Branch accounts and Option 2
5. Foreign investment funds

We welcome the consultation process that you foreshadowed in your Press Release of 11 November 1999. It is vital that the issues raised in the attachment are dealt with effectively by this process. I understand that the thin capitalisation issues will be discussed with Treasury and the Tax Office in early February.

We look forward to a constructive dialogue with Treasury and the Tax Office, with intent of delivering a thoroughly efficient tax system that serves Australia well with the increasingly competitive global markets for banking and commerce.

Yours sincerely

Robert Webster
Executive Director

ATTACHMENT

1. Consolidation Issues

The inability of non-resident entities, including Australian branches, to consolidate with other wholly-owned Australian resident group entities under the Review of Business Taxation (RBT) proposals (see recommendation 15.1) could create a number of problems. These are considered below under a number of headings.

- ***Tax loss grouping***

Currently, Part IIIB of the 1936 Income Tax Assessment Act extends the operation of Subdivisions 170-A and 170-B of the 1997 Act to allow revenue loss and capital loss transfers between an Australian branch of a foreign bank and a 100% Australian resident subsidiary of that bank.

The RBT recommends that consolidation be limited to Australian resident entities only, which would exclude foreign branch banks. As an inducement to consolidate, the RBT contemplates the repeal of the current grouping provisions (recommendation 15.1(iii)). However, the RBT has recognised the need for some continued capital gains tax rollover relief on asset transfers involving non-resident entities, as they are not eligible to consolidate (recommendation 15.2(c)).

The RBT does not mention the need to retain the existing provisions that permit loss transfers between a foreign branch bank and an Australian subsidiary of the bank, though it forms part of the current policy and law. However, as entry into a consolidated group is not available to foreign branch banks, there does not appear to be any reason to alter policy or repeal the Part IIIB loss transfer provisions.

The entire discussion in the RBT's *A Platform for Consultation* in respect of consolidation and the concurrent repeal of the grouping provisions focuses on resident entities only and paragraph 26.69 states that "the availability of a consolidated tax regime removes the need to retain the current grouping provisions". This argument clearly does not apply in respect of foreign branch banks.

The integrity issues associated with the current loss grouping provisions involving resident entities can be sufficiently dealt with in a branch/subsidiary loss transfer situation via cost base adjustments – as is recognised with the proposed retention of asset rollover relief where a non-resident entity is involved (recommendation 15.2(c)).

Any tax value adjustments should only be required in respect of the shares in the resident subsidiary which transfers losses to the branch bank (if indeed any value has been shifted from shares/debts held by the bank in that subsidiary as a result of the loss transfer). Transfers of losses from branch to subsidiary do not give rise to the need for any tax value adjustments as the shares in the foreign bank are not within the Australian tax net. In any event, tax loss transfers from branch to

subsidiary could not result in loss cascading or loss duplication, as the subsidiary (income company) can only increase in value as a result of the loss transfer (where a less than commercial value subvention payment is made) or otherwise maintain its value (where a commercial value subvention payment is made).

Finally, many banks operate in Australia through both a branch and a subsidiary as a consequence of the inability of foreign branch banks to borrow section 128F funds that are free of interest withholding tax. In contrast, locally incorporated banks with which the branches compete can directly raise section 128F funds. I raised this anomaly with you on 4 November last and requested that branches be given equal access section 128F funds. If this does not occur, then there should be some avenue by way of consolidation or transfer of losses (grouping) to transfer losses between the subsidiary and the branch.

- ***Australian resident holding company***

Existing foreign owned groups that do not have a common resident holding company in Australia will be allowed to consolidate without restructuring, subject to the establishment of a "virtual" resident head company.[1] Any new companies brought within the consolidated group are to be positioned as a subsidiary of an existing consolidated entity. The new companies referred to here are those that become wholly owned "after the date of announcement". It should be clarified that this date means 21 September 1999 as opposed, for example, to 22 February 1999.

- ***Wide definition of distribution***

The inability of a foreign branch bank to consolidate with wholly owned resident subsidiaries of the bank gives rise to the potential application of the comprehensive definition of distribution (recommendation 12.1) in respect of dealings between the foreign bank and the consolidated group in Australia and, perhaps, a withholding tax cost should that distribution be taken to be unfranked. This proposed broad definition effectively results in a domestic transfer pricing regime for dealings between the Australian branch and the Australian subsidiaries of the bank.

- ***Non-commercial loans***

The proposals for treating non-commercial loans from a member to a closely held entity depend on the definition of "closely held". The RBT defines "closely held" as an entity that is not widely held and defines a "widely held" entity to be one where the membership interests are **held** by not fewer than 300 persons **and** the 20%/75% test is met (recommendations 6-21 and 6-22).

It would seem that a wholly-owned subsidiary of a listed entity would be "closely held", as the RBT's definition appears to focus on the immediate holding as opposed to the ultimate beneficial holding of the shares in that subsidiary.

[1] This being an existing Australian resident company nominated by the group to act in that role.

Consequently, any non-commercial loan funding arrangements between a foreign bank and its subsidiaries (which cannot form a consolidated group) are proposed to be treated as equity subject to the profits first and slice rule on repayment.

Inappropriately for banks, the definition of "commercial loan" will rely on the criteria for an "excluded loan" currently in Division 7A of the 1936 Act (recommendation 12-22). A loan will be "uncommercial" if there is no written loan agreement, if the interest is less than the variable housing loan rate (rather than an inter-bank lending rate) and if the term of the loan exceeds 25 years (if secured over real property) or 7 years (in all other cases).

The impact of this proposal on intergroup funding and moneymarket/treasury operations is drastic and presumably unintended. For example, it would appear to negate the ability of a foreign bank to fund its subsidiaries on a competitive basis (referable to interbank rates), yet, if such uncompetitive funding rates were applied, the excess of the variable home loan rate over an arm's length interbank rate would presumably constitute a distribution under the proposals for a wide definition of "distribution" (recommendation 12-1).

2. Thin Capitalisation

The following issues arise or require clarification as a consequence of the proposals for a wider thin capitalisation regime (recommendations 22-1 to 22-4).

Broadly, these proposals seek to apply a consistent thin capitalisation rule to both branch bank operations and subsidiary operations. A safe harbour gearing level is proposed for banks and financial institutions that are subject to capital adequacy rules, based on the capital levels reported for regulatory purposes, whether in Australia or in the home jurisdiction if a branch operation (recommendation 22-4(a)). Where the financial institution is not subject to capital adequacy rules, then a 3:1 safe harbour gearing level is proposed, excluding debt which is on-lent, capped at a maximum gearing level of 20:1 (recommendation 22-4(b)).

Where the applicable safe harbour test is not satisfied, then it is proposed that an arm's length test be used to determine the appropriate gearing level for a particular Australian operation (recommendation 22-2(b)), based on, among other factors, the worldwide gearing of the group, the nature of the Australian operations and Australian assets and global industry practices (recommendation 22-2(c)). Further, the thin capitalisation regime is to be strengthened by applying to the "total debt" of the Australian operations of the foreign bank (recommendation 22-1).

- ***The safe harbour test***

For financial institutions, which are subject to capital adequacy rules, the safe harbour test will be based on capital levels reported for regulatory purposes. Australian regulatory capital requirements for banks are consistent with the Basle framework, which is adopted in most of the home jurisdictions in which foreign banks operating in Australia are located. Therefore, basing the safe harbour test

on regulatory capital requirements would do no more than impose an arm's length test, particularly when the factors set out in recommendation 22-2(c) are taken into account.

In effect, financial institutions that are subject to capital adequacy requirements effectively would not have a safe harbour thin capitalisation gearing ratio available to them. The safe harbour test should be capable of general application and the benchmark should not depend on an individual bank's circumstances. It should be a legitimate alternative to an arm's length test and involve a realistic benchmark ratio that enables the efficient and competitive conduct of Australian banking business and must be readily able to be complied with.

In this regard, we note that the Australian Taxation Office (ATO) has extensively researched a capital allocation model for foreign branch banks that utilises the tools of prudential regulation, including capital adequacy. The model attempts to allocate the regulatory capital of the global bank to the branch in proportion to its holding of the bank's risk weighted assets. In practice, this is a very complex task, as banks are prudentially regulated on a consolidated global basis and the model attempts to extract the Australian branch as a separate entity from this.

This model is also being considered in the OECD and potentially forms the basis of a multilateral agreement on branch capital allocation. This would be welcomed by the Association, as a means to remove existing expense black holes attendant with the notional equity requirement. However, significant implementation problems have to be overcome and the methodology is not yet sufficiently refined to be considered operational. This increases the need for an alternative safe harbour test that is easy for banks to assess their compliance with.

- ***Regulatory capital***

From a policy perspective, if regulatory capital is maintained, an arm's length gearing should be accepted as being present and the thin capitalisation rules should be taken to be automatically satisfied. However, the interaction of regulatory capital and tax debt/equity concepts need to be considered in the application of thin capitalisation rules outside of this framework.

Where a financial institution is subject to Australian capital adequacy rules, it would be required to maintain capital equivalent to 8% of risk weighted assets, with core capital (Tier 1 capital) being at least 50% of that amount, with supplementary capital (Tier 2 capital) comprising the balance. Some elements of both Tier 1 and Tier 2 capital may currently be tax deductible, being treated as debt for income tax purposes (for example, perpetual subordinated debt instruments). Further, some elements of Tier 2 capital are non-fund items such as general provisions for doubtful debts and asset revaluation reserves.

The strengthened thin capitalisation regime is to apply to the "total debt" of the Australian banking operations (recommendation 22-1). We understand that it is the intention that the meaning or definition of "debt" for thin capitalisation purposes will be consistent with that adopted elsewhere in the RBT. In this

regard, we note that that some components of regulatory capital may satisfy the "debt tests" of recommendations 12-10 and 12-11, which may give rise to some inconsistency in the treatment of banking institutions that compete with each other. The implications of this are not considered in the RBT and need to be discussed with industry in detail.

These issues may be exacerbated when branch operations are considered, inasmuch as the tax treatment in the home jurisdiction of the various components of regulatory capital, as either debt or equity, may need to be factored in.

- ***On-lending rule***

The carve out of on-lending by financial institutions, subject to a maximum gearing ratio, is vital to maintain the competitiveness of merchant banks. The thin capitalisation ratios will in effect impose a minimum capital ratio of 4.8% on merchant banks. This is higher than the Tier 1 requirement for banks (which may also include some 'debt' instruments, as discussed above). To maintain competitive balance, we recommend that a maximum gearing ratio of 25:1 be adopted for 'unregulated' financial institutions, like merchant banks.[2]

The manner of items included in the 'on-lending' rule is not discussed in the RBT and its application is unclear. For example, will cash and other liquid investments typically held by all financial insitutions be treated as on-lending for thin capitalisation purposes? Detailed information on the intended application of the rule should be provided, so that industry can provide constructive comment that would assist the efficient application of the rule.

- ***Range of financial institutions subject to capital adequacy rules***

It is not clear that the contemplated range of financial institutions subject to capital adequacy rules includes securities dealers that are subject to Australian Securities and Investments Commission (ASIC) and regulated exchange capital requirements.[3] We recommend that regulated securities dealers, stock exchange brokers and futures exchange brokers should be deemed to automatically satisfy the arm's length thin capitalisation test. This would help to preserve the competitiveness of Australia as a location to conduct financial transactions.

We note that the Government's CLERP draft legislation for the regulation and licensing of financial markets, due to be released early in the new year, may broaden the range of non-APRA regulated entities subject to capital requirements. The RBT proposals should take account of developments in this area, as it could reduce compliance costs for industry, while preserving the integrity of the thin capitalisation regime.

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[2] The lending activity of merchant banks is not prudentially regulated. However, many other aspects of merchant banks' business are tightly regulated; for example securities dealing, foreign exchange trading and fundraising.

[3] Securities dealers are broadly required to hold 3-5% of their adjusted liabilities in the form of net tangible assets or surplus liquid funds (see ASIC Policy Statement 42).

- ***Consolidation issues***

The application of the thin capitalisation ratios to the consolidated group involving either a financial institution subject to capital adequacy requirements and other financial institutions not subject to those requirements or to groups comprising both financial institutions and non-financial institutions need to be addressed. We would appreciate some advice on the Government's intention in this regard, with a view to commenting constructively on the practical implementation of the proposal.

In addition, as mentioned above, foreign branch banks must use a related Australian subsidiary entity to raise section 128F funds on their behalf, but the branch and subsidiary would be unable to consolidate. This has important implications here, as the thin capitalisation requirement being applied twice in respect of the same funding, which would competitively penalise foreign branch banks.[4] Clearly, this anomaly must be corrected.

- ***OBU carve-out***

Consistent with the policy in section 160ZZZB of the 1936 Act, offshore banking unit (OBU) interest expense should not be subject to thin capitalisation ratios.

3. Proposed Withholding Arrangements

Recommendation 21-6 proposes a new withholding tax regime in respect of Australian sourced income and gains on disposal of assets subject to Australian tax derived by non-residents, other than through an Australia permanent establishment and other than in respect of interest dividends and royalties in respect of which the existing withholding tax arrangements will apply (recommendation 21-6(a)). In this respect, changes to Australia's source rules are also proposed (recommendation 23-2(c)) which will focus on a functions, assets and risks analysis. This proposed withholding tax will not be a final tax and the tax will be withheld at the time of payment at 10%, in respect of asset disposals, and at the prevailing company tax rate on other payments (recommendation 21-6(b)). The amount withheld will ultimately be available as a credit in the non-resident's Australian tax assessment (recommendation 21-6(c)).

The impact on financial markets of these measures is Draconian and can only lead to a weakening of those markets. For example, the proposals could result in a withholding tax, at 36%, on swap payments offshore, and a 10% tax on stock exchange sales by non-residents. Such tax will ultimately flow-through to pricing and thus is likely to inhibit market depth and liquidity and competitiveness. There must be an appropriate carve-out for financial market participants (including derivative, bond, securities and moneymarket participants).

[4] In this circumstance, the affected branch would have to hold twice the normal thin capitalisation equity requirement in respect of that funding.

4. Branch Accounts and Option 2

Recommendation 22-11(c) proposes that branches be required to prepare separate financial accounts for taxation purposes, that include dealings with other parts of the entity. It is submitted that the Part IIIB requirement for Australian branches of foreign banks is sufficient and that this recommendation should not include such taxpayers. In any event, clarification is required as to whether the accounts are to be prepared based on accounting standards applicable in Australia or the home jurisdiction and whether the branch accounts are required to be audited.

The cash flow approach of calculating taxable income (see recommendation 4-1) gives rise to particular difficulties for branch bank operations. Broadly, as a branch operation, cash flow statements are not prepared in the manner contemplated, but rather for risk management and inventory control purposes, with a large amount of netting carried out. The proposed cash flow approach would entail significant systems and compliance difficulties for branch bank operations.

5. Foreign Investment Funds

Many foreign investment banks operating in Australia market financial products that add to competition in funds management here. Your announcement in December 1997 that, as part of the *Investing for Growth* program, certain US funds would be exempt from foreign investment fund (FIF) rules greatly enhanced the scope for US funds to provide that competition on a "tax comparable" basis. This initiative was subsequently enacted in Taxation Laws Amendment Act (No. 2) 1999.

Recommendation 16 (i) of the RBT requires a collective investment vehicle (CIV) to be an Australian trust. This would mean that an Australian investing in a foreign company through a domestic fund would be taxed on a flow-through basis, while the same investment through a foreign fund would be taxed at full income tax rates on all distributions. Unfortunately, this would place a substantial disadvantage on foreign funds, which would be accentuated by administrative difficulties in complying with the new regime.

These problems would nullify the boost to competition achieved through the *Investing for Growth* FIF initiative. It would also represent an apparent reversal of the FIF policy; a policy inconsistency that would harm the perception of Australia as a place to conduct financial business, especially given the favourable international attention to the FIF's initiative.

We understand that the Department of Treasury is reviewing this matter, after industry representations that the Association supported, and will soon to refer it to your office, as Treasurer. There is a strong case for you to remove the potential blockage to competition from foreign funds, for example, by determining that FIF-exempt offshore funds be included in the definition of CIV. It is to be hoped that you can affirm the prior policy and do so as soon as possible to put to an end the uncertainty caused by this issue.