17 July 2007

Foreign Source Income Anti-Tax Deferral Review
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
Parkes ACT 2006

Email: taxboard@treasury.gov.au

Dear Mr Warburton,

The Board of Taxation
Review of the Foreign Source Income Anti-Tax-Deferral Regimes
Submissions in response to 25 May 2007 Discussion Paper


The ABA has been granted an extension to make submissions until close of business on 17 July 2007.

1. Introduction

The ABA is the peak body for the Australian banking industry – its 26 members include all of Australia’s major banks. Members of the ABA collectively paid $8.1 billion of corporate income tax for the 2006 year, an increase of 21% from the preceding year. This sum amounted to nearly a quarter of all Australian corporate income tax collections for the year.

2. Executive Summary

The ABA and its members have been strong supporters of the need for substantial reform to Australia’s Foreign Source Income Anti-Tax-Deferral Regimes to develop a more efficient tax system and to reduce compliance costs.
The ABA has had the benefit of reviewing the submission prepared by Ernst & Young and the Corporate Tax Association of Australia and dated 16 July 2007 ("CTA Submission"), and endorses that submission.

However, there are a number of issues that are of specific relevance to the banking industry which are either not dealt with in the CTA Submission, or on which the ABA and its members wish to provide further detail, and these are dealt with in the attached document.

The ABA looks forward to further and close consultation with The Board of Taxation as the review of Australia’s Foreign Source Income Anti-Tax-Deferral Regimes progresses.

Yours sincerely

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Tony Burke
Review of the Foreign Source Income Anti-Tax-Deferral Regimes

Submissions in response to The Board of Taxation Discussion Paper

The Australian Bankers’ Association Inc (“ABA”) makes the following submissions on the issues raised in The Board of Taxation’s discussion paper entitled “Review of The Foreign Source Income Anti-Tax-Deferral Regimes” (“Discussion Paper”).

For ease of reference, the submissions are organised by topic.

Part A: Harmonised regime

1. Single regime

Subject to the three comments below, the ABA broadly supports the concept of the FIF and CFC regimes being harmonised by collapsing them into a single regime (as envisaged by paragraphs 6.10ff of the Discussion Paper).

However, the ABA’s support is given on the proviso that there is certainty that the various compliance saving exemptions within the existing CFC and FIF regimes would continue to be available. For example, it is particularly important to ABA and its members that the following exemptions continue to be available:

- The current CFC concessions for AFI subsidiaries (see ss.449 and 450); and
- The FIF exemption in relation to foreign banks (see Division 4 of Part XI).

Further, the ABA considers that any harmonisation should incorporate both the functional improvements to existing exemptions and the additional exemptions discussed in the submissions made below.

Finally, the ABA is opposed to the harmonisation of the CFC/FIF provisions with the transferor trust regime. In particular, the ABA considers an amendment is required to ensure the transferor trust regime does not apply to corporate taxpayers. We do not believe there is any basis for applying the transferor trust regime to corporate taxpayers (in particular, to listed public companies).

2. Framework for the design of the “harmonised regime”

The ABA recommends that the Board of Taxation should evaluate the design of the “harmonised” design following a defined framework. A diagrammatic representation of the proposed framework is attached as Appendix A.

ABA recommends that in the design of the “harmonised regime”, the Board of Taxation should focus on the following areas:

- Types of interests that should be subject to the attribution regime;
- Exclusions from the attribution rules; and
• The calculation of attributable income.

These matters are discussed further below.

2.1 Types of interests

ABA recommends that the focus of the review should be to apply consistent rules across all accrual regimes. The Board of Taxation should focus on the nature of “interests” held by a taxpayer in the foreign entity that should be subject to the accrual rules.

2.2 Exclusion from the attribution rules

Currently, each accrual regime has its own set of general and specific exemptions. The exemptions are provided to taxpayers where there is limited risk of tax deferral.

The ABA considers that the focus of the review should be to ensure that, given the changing nature of global investment, the current exemptions are available in the manner where they were originally intended. Further, in certain circumstances, new exemptions should be available having regard to the new global investment environment and the current scope of Australia’s international trade.

We submit that, under the “harmonised” regime:

• exemptions should apply consistently;
• certain entities engaging in certain active business should be completely or largely exempted from the attribution regime; and
• certain taxpayers should receive complete exemption.

Some further detail on these matters is set out below. However, a more detailed discussion can be found in Parts B to D of this submission.

2.2.1 Listed country exemptions

The ABA submits that there should be a complete exemption from the “harmonised” regime for CFCs and FIFs (which are companies) and which are resident in a listed country. See further Part B of this submission.

2.2.2 Active business exemption

The ABA submits that the current “active business exemption” under the FIF regime should be provided to CFCs carrying on eligible business activities in foreign countries.

The current active business exemptions should be expanded in relation to legitimate banking, financing and leasing activities.

See further Parts C and D of this submission.
2.2.3 Specific industry exemptions

Specific industry exemptions should be maintained and expanded to cover all complying superannuation funds and Australian collective investment vehicles.

See further Part B of this submission.

2.2.4 Distribution and motive based exemptions

An exemption from the attribution rules should be available to certain publicly listed companies that can demonstrate that there is no motive in deferring income offshore. See further Part B of this submission.

Further, the ABA recommends that a motivation or purpose test should be included as a “last resort” exemption if other exemptions were not met. See further Part E of this submission.

3. Calculation of attributable Income

As detailed in other parts of this submission, ABA recommends that the current methods for calculating attributable income should be simplified to lessen the compliance burden for taxpayers with extensive operations offshore. In particular, the ABA recommends that more choices to be available to taxpayers to determine attributable income.

The ABA recommends that taxpayers can have the option to choose any of the following methods for calculating attributable income:

- Branch equivalent method;
- An expanded Market Valuation method;
- Profit and loss (calculation) method; and
- Benchmark or deemed rate of return method.

As detailed in the following Parts of this submission, these methods should be simplified to reduce the level of complexities and restrictions in the current regimes.

Part B: Submissions applicable to both the CFC and FIF provisions

1. Exemption for Australian listed investors

The CTA Submission proposes an exemption from the anti-tax-deferral regimes for Australian widely held public companies. The ABA endorses this submission.

The ABA also suggests that an option to consider in addressing any “integrity” concerns with such an exemption could be the inclusion of a requirement specifying a minimum dividend payout ratio (say, 60%) and/or minimum franking percentage (say, 75%) for the Australian widely held public company to qualify for the exemption.
2. Exemption for listed country entities

The ABA would not support the abolition of the concept of "comparable listed countries" without fully understanding how it would reduce the compliance burden for the taxpayer. The listed country concept currently provides an effective means of reducing the amount of information which is required from these countries.

The ABA has two alternative submissions in relation to entities resident in listed countries.

2.1 Complete exemption

Given the extremely narrow prospects of any leakage to the revenue, the ABA submits that there should be a complete exemption from the CFC/FIF regimes for CFCs and FIFs (which are companies) and which are resident in a listed country.

Ideally, China should also be included on the list of exempted jurisdictions.

2.2 Review of list of designated concession income

If the above submission is not accepted, then the list of designated concession income should be re-examined. In particular, New Zealand capital gains relating to the disposal of shares should not be specified on the list of designated concession income unless a significant portion of the value of the shares represents Australian taxable assets.

The ABA does not consider that the removal of New Zealand capital gains from the list of designated concession income in these circumstances represents a significant risk to the integrity of the CFC measures. More particularly, the ABA does not believe the removal of this item represents a risk to the Australian revenue. We are not aware of any empirical data which would support a proposition that the New Zealand CGT exemption represents a significant risk to the Australian revenue. The Government has significant flexibility in their power to amend the EDCI regulations if anti-avoidance behaviour is detected. In addition, Part IVA may apply.

By removing New Zealand capital gains from designated concession income, it will no longer be necessary for taxpayers to undertake an active foreign business percentage ("ABFAP") calculation in accordance with the CGT participation exemption (refer Division 768) to produce the same outcome. Accordingly, the removal of New Zealand capital gains from designated concession income represents a significant compliance saving for taxpayers with significant active New Zealand investments. We would suggest that at the very least this item could be modified to align the treatment of New Zealand capital gains with the treatment of UK capital gains which are exempt from UK taxation under the substantial shareholding exemption, where designated concession income only arises where the assets have the necessary connection with Australia.
3. Exemption for Australian managed funds and complying superannuation funds

The ABA supports the recommendation that offshore investments by Australian managed funds and complying superannuation funds be excluded from the CFC and FIF rules.

However, further detailed consultation is required in this area as listing/registration should not be the only way of qualifying for such an exemption. For instance, regard could be had to an accounting income based payout ratio test.

Part C: CFC provisions

1. “Financial intermediary business” definition

The definition of “financial intermediary business” in s.317 is central to the availability of the CFC concessions for AFI subsidiaries in ss.449 and 450, yet that definition has remained static while the nature and scope of activities ordinarily carried on by financial intermediaries (including banks and their subsidiaries) has expanded in the years since the definition was inserted.

In particular, banking activities no longer merely include the "lending of money". For instance, structured financial products, derivatives and securities (including leasing transactions and credit risk products) etc are common products provided to banking customers.

The ABA submits that the definition of “financial intermediary business” should be updated to take into account activities ordinarily carried on by financial intermediaries including banking, financing and leasing activities. Consultation would be necessary to settle the precise scope of the activities to be covered.

Further, the ABA submits that the definition should include a regulation making power to allow the broader definition to be further bolstered, as further developments occur.

2. “AFI subsidiary” definition

The definition of “AFI subsidiary” in s.326 is also central to the availability of the CFC concessions for AFI subsidiaries in ss.449 and 450.

The ABA has two alternative submissions in relation to broadening the scope of the “AFI subsidiary” definition.

2.1 “AFI” definition

The ABA recommends that detailed consideration be given to expanding the definition of Australian Financial Institution (“AFI”) (in section 317) to include all taxpayers holding interests (directly or indirectly) in foreign entities conducting offshore banking, financing and leasing business activities.
2.2 “AFI entity” definition

Legislation facilitating restructures of banking groups to interpose a non-operating holding company ("NOHC") has recently been enacted (Financial Sector Legislation Amendment (Restructures) Act 2007). Under such restructures, offshore banking entities may now be held by a specific banking NOHC, rather than by the ADI itself. APRA will continue to regulate offshore banks in these circumstances (i.e. the offshore banking entities must be held by a specific banking NOHC, which itself will be subject to regulation by APRA). Accordingly, the ABA considers it is appropriate that the ultimate parent NOHC (i.e. the attributable taxpayer) be granted access to the special rules relating to AFI subsidiaries in these circumstances.

This could be achieved by expanding the current definition of “AFI entity” in s.326(2) to include a reference to:

"(a) a company that is an AFI;
(b) a consolidated group a member of which is a company that is an AFI; or
(c) a 100% subsidiary of such a company or consolidated group."

3. Scope of special rules for AFI subsidiaries

The ABA submits that the scope of the special rules for AFI subsidiaries in ss.449 to 450 should be expanded to apply to income from all of the activities described in the expanded definition of "financial intermediary business" referred to in submission 6 above.

In addition, the ABA submits that these special rules for AFI subsidiaries should be expanded to apply to tainted rental income.

4. Interaction of base company rules with transfer pricing

The submission prepared by Ernst & Young and the Corporate Tax Association of Australia ("CTA Submission") proposes that the "base company income" provisions be removed on the basis that, among other things, the transfer pricing provisions adequately deal with any risk to the revenue arising from base company income. The ABA supports this submission.

In addition, the ABA is concerned that the current overlap between the transfer pricing rules and the definition of tainted services income creates an incentive to move related party transactions offshore. This can be demonstrated by the following practical example.

A CFC that is an AFI subsidiary and financial intermediary has excess funds for a period of time due to a timing difference between raising funding and acquiring assets. It wishes to place the excess funds temporarily on deposit. If does so with either its Australian parent acting through its head office offshore banking unit (OBU) or acting through an offshore branch (eg Singapore). In both instances an arm's length interest rate on the deposit would be earned. If the parent acts
through its head office OBU, the parent earns a slightly better margin on the funds and ignoring the impacts of the CFC regime, tax would be indifferent eg 10% rate in the OBU and 10% rate in Singapore with s.23AH applying to the Singapore branch’s profits.

However, as a result of the operation of the CFC rules, where the CFC places the deposit with Singapore branch it will be able to benefit from the s.449 exemption on the interest earned, whereas if the CFC places the deposit with the OBU the interest income will be tainted services income and s.449 would not be available, Australian tax becoming payable under Part X.

Accordingly, the effect of the attribution of tainted services income is to create an incentive to move certain related party transactions offshore, notwithstanding that they were priced on arm’s length terms.

Given the robustness of the Australian transfer pricing rules as well as the increased global focus on transfer pricing, it is argued that the overlap between transfer pricing and CFC provisions is no longer required and at times is actually harmful to the Australian revenue base.

The proposition that the CFC rules create a bias away from Australia can also be demonstrated outside the banking context. For example, the same analysis and conclusions apply in circumstances where a CFC resident in an unlisted country manufactures equipment for which there is a market in both NZ and Australia that generates the same pre-tax returns. The CFC could sell the equipment to both its Australian parent or NZ sister company on arm’s length terms, however where the CFC does not pass the substantial manufacture test and therefore would be attributable on its income from sales to its Australian parent, a clear bias away from Australia exists.

5. **Grouping of CFCs in the same jurisdiction**

The CTA Submission submits that some grouping recognition of CFCs is needed. The ABA supports this submission.

In addition, the ABA considers that the rationale provided in the CTA Submission for “grouping” CFCs is particularly compelling for CFCs that are resident in the same country.

Accordingly, if it is not the case that all transactions between CFCs are to be disregarded for CFC purposes, then the ABA submits that an attributable taxpayer should be able to elect that transactions between CFCs that are resident in the same country should be disregarded for the purposes of:

- determining whether they pass the “active income test”; and
- calculating their passive income.

In addition, at a minimum, CFCs within the same jurisdiction should be able to group losses with assessable income in determining the attributable income of a taxpayer.
6. **CFCs subject to roll-over relief under foreign law**

The ABA recommends that the CFC roll-over rules be expanded to include CGT roll-over relief for the disposal of assets where roll-over relief is provided under the laws of the foreign country. That is, where a CFC which is a resident of a foreign country transfers an asset and roll-over relief is available under the tax law of that foreign country, it is our view that it would be appropriate for CGT roll-over relief to automatically apply under the CFC rules on the same basis.

7. **Part year CFC calculations**

The CTA Submission submits that CFC attributable income should be apportioned to take into account part-year ownership.

The ABA submits that CFC attributable income should be apportioned in the year of acquisition to take into account part-year ownership. Consultation would be necessary to determine the appropriate method of apportionment.

8. **Passive income test - requirement for Australian actuary**

Section 446(2) currently refers to calculations undertaken by foreign life insurance companies being required to be performed by a “Fellow or Accredited Member of the Institute of Actuaries of Australia”. This requirement is impractical to comply with as a foreign life company would reasonably be expected to use an actuary who is qualified in their home country, rather than in Australia.

The ABA submits that the requirement should be simply for the calculation to be performed by a qualified actuary.

It is noted that similar issues arise in the context of the capital gains tax participation exemption in s.768-530 as a result of the interaction with the CFC provisions.

**Part D: FIF provisions**

1. **Determining FIF income**

The ABA has two submissions in relation to the methods of determining FIF income.

First, the ABA endorses the submission in the CTA Submission that the rate applied under the deemed rate of return method should not be penal – and should instead reflect commercial reality in terms of a proxy for return on investment. One appropriate benchmark may be the dividend payout ratio for ASX 200 companies.

The ABA considers that this submission is particularly compelling given that currently no other method is permitted in respect of unlisted equity interests where the taxpayer has insufficient information to perform branch equivalent calculations.
Second, the ABA submits that both the “market value method” and the calculation method should be expanded to permit FIF income to be calculated based on a FIF’s audited accounts – provided they have been subject to fair value accounting.

2. FIF and the “banking” exemption

The ABA has previously raised its concern that the “banking” exemption in Division 4 of the Part XI is not sufficiently broad to take into account the specific issues associated with investing in banks resident in certain developing Asian countries. This is because, in certain countries, foreign residents can only acquire non-controlling stakes in banks (ie, the FIF provisions apply), yet:

- no exemption is available under the active business exemption in Division 3, as the investee bank’s activities will typically not be “eligible activities”; and
- often no exemption is available under Division 4. For example, this may be because:
  - the investee bank may not be listed, or
  - the investee bank may be listed, but not on an “approved stock exchange; or
  - the investee bank may be listed, but the “widely” held requirement cannot be met.

Therefore as a result of the application of the Australian FIF rules, Australian banks are placed at a competitive disadvantage to foreign banks also investing in these emerging markets.

The ABA submits that the following alternatives should be considered as a way to remedy this disadvantage:

- Relaxing the “banking” exemption in respect of the matters raised above.
- Amending the “banking” exemption so that it applies to an interest in a company that is a foreign regulated bank and is principally engaged in banking business.
- Where the shareholder is an AFI or AFI subsidiary, excluding “financial intermediation services” from the list of non-eligible activities for the purposes of the active business exemption in Division 3.

3. Interaction of FIF and TOFA stages 3 and 4

The ABA submits that it should be made clear that, where the fair value election has been made under proposed Subdivision 230-B of TOFA stages 3 and 4, no further attribution or compliance arises under the FIF provisions.
Part E: Other matters

1. Consequential effects of removing “control” test

If the concept of “control” for CFC purpose were to be removed, it would nevertheless be necessary to preserve the concept in order that the operation of a series of other provisions – which rely upon that concept – be preserved.

Of particular interest to the ABA is that the status quo in relation to the meaning of “controlled foreign entity equity” in the thin capitalisation provisions be preserved. This concept is relevant to calculating the “adjusted average equity capital” of an outward investing entity (ADI) – and is ultimately defined by reference to the Part X concept of control (see Subdivision 820-H).

More specifically, the ABA is concerned that, if the concept of “control” for CFC purposes were to be removed, equity interest and debt interests in what are currently FIFs should not then constitute “controlled foreign entity equity”.

The ABA submits that this is an appropriate outcome given that this aspect of the thin cap provisions is intended to deny debt deductions to the extent that ADIs have impermissibly shifted profits into foreign controlled entities. That is, this provision is clearly aimed specifically (only) at situations involving “control”.

2. Section 404 review

The ABA does not believe the expansion of the general exemption for all foreign non portfolio dividends (as defined in s.317) provides any policy grounds for the repeal of the portfolio dividend exemption provided for dividends received from s.404 countries. More specifically, the ABA recommends that the s.404 portfolio dividend exemption be maintained.

3. Motivation or purpose test

The ABA would only support the concept of a motivation or purpose test if it was included as an exemption of last resort if no other exemptions are available. A "purpose test" could be available to taxpayers if for some reason they were unable to satisfy an entry level active business test. It would be difficult for a purpose test on its own to provide taxpayers with sufficient certainty.

4. Review of foreign hybrids

The ABA submits that the scope of the current review should be expanded to cover foreign hybrids.
Preferred architecture to facilitate harmonisation

Interest in Foreign Entities (CFC/FIF)

1. Listed Country Exemption
2. Active Business Exemptions
3. Specific Industry Exemptions
4. Distribution & Motive-based Exemptions
5. Attribution calculation methods

Exempt from accruals taxation

Branch Equivalent (CFC) Method
Modified Calculation Method
Market Value Method
Benchmark dividend Method (as in NZ)