18 December 2012

The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

By email: taxboard@treasury.gov.au

Dear Sir/Madam

Review of Tax Arrangements Applying to Permanent Establishments

The Australian Financial Markets Association (**AFMA**) welcomes the opportunity to provide input to into aspects of the review by the Board of Taxation (**the Board**) of the advantages and disadvantages of Australia adopting the functionally separate entity approach to the determination of the profits attributable to a permanent establishment.

AFMA is the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets. AFMA represents over 130 market participants, including Australian and international banks, leading brokers, securities companies, State Government treasury corporations, fund managers, and traders in electricity and other specialised markets.

The structure of AFMA's submission is to initially provide context regarding the use of permanent establishments by AFMA members, both in terms of prevalence and also the types of transactions undertaken. The submission then sets out our support for the functionally separate entity approach to be adopted in both the domestic law and Australia's network of Double Taxation Treaties. Finally, we specifically respond to a number of technical questions posed by the Board's discussion paper (**the Discussion Paper**), with a particular focus on reforms to Part IIIB of the *Income Tax Assessment Act* 1936 (**the 1936 Act**) and the LIBOR Cap.

Australian Financial Markets Association
ABN 69 793 968 987
Level 3, Plaza Building, 95 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7955 Fax: +61 2 9776 4488
Email: info@afma.com.au Web: www.afma.com.au

1. Overall Policy Objectives and Context

Question 2.1 of the Discussion Paper seeks stakeholder commentary on:

- Reasons for using a permanent establishment rather than a subsidiary;
- The type of activities undertaken by and channelled through permanent establishments; and
- The size or extent of use of the permanent establishments relative to any subsidiaries that particular businesses use.

Comments in relation to each of these questions, in respect of the AFMA membership, are set out below:

1.1 Reasons for Using a Permanent Establishment rather than a Subsidiary

The reasons for using a permanent establishment rather than a subsidiary entity to conduct business in a foreign jurisdiction tend to be common internationally; that is, key motivations are common to both inward and outward branches. For ease of analysis, we have concentrated our feedback here on the situation for inbound branches, though we expect similar factors are prevalent in decisions by domestic banks to operate through branches in foreign jurisdictions.

Foreign banks in Australia operate as either:

- A licensed branch bank - wholesale banking only;
- A locally capitalised licensed bank subsidiary – retail and wholesale banking; and
- A money market corporation – wholesale business only.

The members of AFMA that are headquartered overseas generally operate through a permanent establishment as opposed to a subsidiary. By way of illustration, there are currently 48 foreign banks operating in Australia, 40 of which operating through a permanent establishment and only 8 through a subsidiary[1]. This ratio reflects, to a large extent, the types of business conducted by foreign banks in Australia.

Regulatory requirements are important to the decision to utilise either a branch or a subsidiary. A banking licence is of significant commercial value to the holder because it provides the holder with the right to offer certain financial services that are otherwise restricted. The most important advantage is the right to accept deposits from the public without the need to issue an accompanying prospectus. The Banking Act requires that retail banking businesses must be placed in a locally incorporated entity (i.e. a subsidiary) as this provides the appropriate level of depositor protection. For banks that operate a wholesale only business, the prudential regulation of foreign bank branches provides a level of regulatory intensity that is more in keeping with the nature of their business.

Non-bank financial institutions (**NBFI**) are another option but, since the mid-1990s, the volume of banking business conducted through money market corporations has declined sharply. There are several reasons for this; APRA has a preference for significant business to be conducted through an

[1] APRA List of Approved Deposit-taking Institutions - http://www.apra.gov.au/adi/Pages/adilist.aspx

Approved Deposit-taking Institution (**ADI**); the commercial benefits of operating through a branch have become more apparent; many (though not all) of the tax and regulatory impediments to branch banking have been removed; and the market environment for NBFIs has become much more difficult post the GFC.

Tax is not a major driver of decisions about utilising branch operations, as reforms to the Australian taxation system have provided much greater tax neutrality between branch and subsidiary operations; a policy position AFMA continues to endorse. However, tax could become a more significant factor as perceived transfer pricing risk has recently increased and the outcome of the Board's review is being monitored closely. The outcome could either enhance certainty to the tax treatment of intrabank business or, conversely, increase the tax risks that a foreign bank branch operating in Australia must shoulder.

In addition to the points noted above, banks generally look to utilise permanent establishments for their overseas operations for a variety of reasons, including the following:

- **Efficient use of capital:** Foreign-owned bank branches can take advantage of their parent's balance sheet and draw on its substantial capital and resources, thereby enhancing their capacity to participate in a broader range of transactions. Moreover, the global bank's capital can be managed at a central point, as the domestic prudential regulator, APRA, does not require a foreign bank branch to hold capital either in Australia or separate from its parent bank - under the Basel Concordat the home regulator is responsible for the global bank's solvency regulation, while the host regulator has prime responsibility for the liquidity of the local branch;
- **Business capacity:** The ability of foreign-owned bank branches to take advantage of their parent's balance sheet strength enhances their capacity to undertake certain types of business, allowing banks to participate in more transactions and in transactions with larger exposures (e.g. infrastructure financing);
- **Governance:** A branch operates under the direct control of the board and senior management of the parent bank, whereas a subsidiary has its own board with its own specific responsibilities (including that owing to its owner, the parent bank);
- **Better integration with global operations:** This advantage is particularly apparent for banks conducting global trading businesses that wish to transact out of the same entity in each market. For example, global banks operate for the full 24-hour day, which involves the transfer of some positions from one part of the bank to another across the relevant time zones. Branch operations are especially valuable to banks that wish to conduct regional or global financial markets transactions through their Australian operation, because of their seamless commercial integration with the parent bank;
- **Reduced administrative and compliance costs:** The use of a single legal entity instead of a locally incorporated subsidiary reduces duplication in terms of administrative costs, such as:
    - the cost of managing a board, including expenses such as directors' fees;
    - the branch can benefit from the terms of global purchase agreements (for example, in relation to data services);
    - a single agreement (for example, based on ISDA documentation) can cover the bank's global business; and

    - operating through a single entity can reduce duplication of regulatory and tax compliance costs;
- **Lower cost of funding:** Operating through a branch structure allows for the local branch to adopt the credit rating of the foreign bank when raising deposit and wholesale market funds, which removes the requirement for credit enhancement arrangements such as parent guarantees, thus avoiding associated costs; and
- **Global financial markets infrastructure:** While domestic financial market infrastructure is vital to the efficiency of our financial markets, the infrastructure to support financial markets, and the OTC markets in particular, is becoming more global with the implementation of the G20 reforms agreed in Pittsburgh in 2009. Branch operations should provide smoother connectivity to global financial market infrastructure, such as clearing houses and data repositories.

1.2 The Types of Activities Undertaken By Permanent Establishments

The typical balance sheet of a foreign bank branch in Australia is quite different to that of the average bank, as illustrated in Table 1. This reflects the institutional nature of their business, which is a segment of the domestic market that is generally more open to competition, including from international players.

Table 1

Relative Balance Sheet Profile of Foreign Bank Branches

(September 2010 – proportion of total assets (liabilities)

	All Banks	Foreign Bank Branches
Assets		
Trading & investment securities	15%	22%
Housing loans	40%	0%
Corporate lending	17%	26%
Intragroup lending	6%	26%
Derivatives positions	5%	9%
Liabilities		
CD funding	12%	30%
Household deposits	26%	0%
Bonds, notes & long term borrowing	6%	18%
Intragroup deposits	7%	10%
Derivatives	7%	9%

Note: Extracted from APRA published data.

Foreign bank branches collectively offer a broad range of services including corporate advice and lending, custody services, agricultural finance, treasury products and are the major underwriters of Australian debt issues, amongst other things. Foreign banks operate through a branch to enable the provision of comprehensive, uniform and cost effective financial services to Australian clients, many of whom operate internationally. This is reflected in the ability to facilitate very large financing arrangements, reduce capital costs and improve access to global markets for their clients.

Because they provide lending and other financial services to Australian businesses, a natural business model for foreign banks is to fund substantially in Australia. Since they are precluded from taking retail deposits, they are required to fund in the wholesale money market and the medium and longer term debt market. In this context, they are also an important avenue for investment by managed funds to obtain short term money market instruments for their portfolios.

The foreign branch bank regime introduced in 1993 has been a successful initiative. Foreign banks have heightened competition in the wholesale banking and financial markets to the considerable benefit of Australian business and the broader community. Foreign bank branches have a much larger presence in the business banking market, largely reflecting the focus of foreign bank branches on wholesale clients in keeping with their regulatory obligations. For example, the Reserve Bank has commented that the foreign bank branch regime has helped to reduce the cost of loan finance to business[2] – margins fell by over 100 basis points prior to the GFC. However, since then the market environment has been more difficult and tax issues have had a greater adverse.

Many foreign bank branches in Australia operate as part of a corporate group presence in Australia. For instance, foreign bank branches provide credit to the Australian economy both directly from their balance sheet and, indirectly, by lending to group entities in Australia that have finance company business or support the securitisation market. This is reflected in a significant element of intrabank business for foreign bank branches.

In addition, most of the major stockbrokers and investment banks in Australia form part of a corporate group that includes a foreign bank branch in Australia. The stockbroking and capital raising market is highly competitive and is serviced by a wide spread of stockbrokers and investment banks. Thus, foreign bank branches are an integral part of the capital markets in Australia assisting in capital raising and risk management by corporates, amongst other things.

The wholesale OTC markets are institutional markets with a broad range of participants, including foreign bank branches. The markets generally attract international participants and, in this context, foreign bank branches provide a wide range of essential liquidity, investment and risk management services to the financial services industry and to their business clients. Anecdotal and survey evidence supports the contention that Australia's wholesale financial markets are very competitive.

Foreign bank branches have a relatively high exposure to business conditions, as they operate in the corporate market and do not have a consumer business base. The margins to be earned in institutional business are tighter than in the retail market, and, reflecting the greater sensitivity to the economic cycle, profits earned tend to be more volatile over time, which has been apparent in the post-Global Financial Crisis (**GFC**) period.

[2] The Reserve Bank of Australia observed in the March 2007 Financial Stability Review:
"Much of the pick-up in foreign-owned banks' business lending growth has been in 'large' loans (defined as loans over $2 million), with these banks accounting for around one quarter of outstanding bank loans of this size. The activity of foreign-owned banks appears to have been one of the catalysts for stronger competition in this market, which in turn has been associated with a contraction in lending margins."

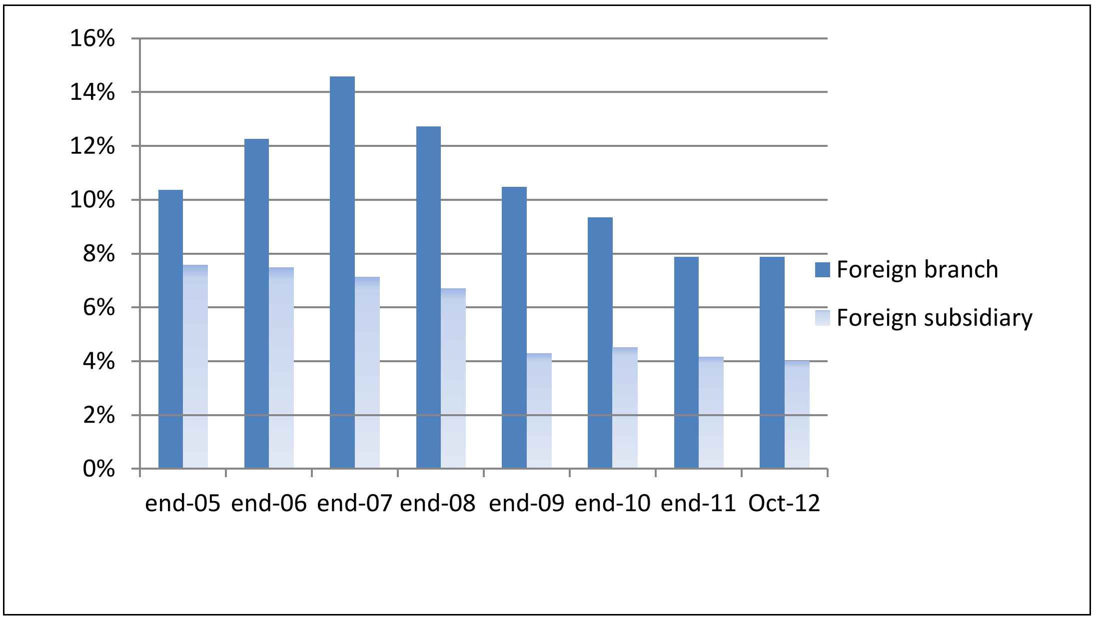
One of the challenges facing foreign bank branches, in keeping with many other financial market participants, is to manage the effects of the GFC and the high Australian dollar on their business and maintain the number of high quality financial markets jobs in Australia. It is evident from AFMA's work with member firms through our market and operations committees that some international banks have relocated staff or transferred trading functions to regional operations based in Hong Kong and Singapore. This process of consolidation is ongoing in some cases. In relation to back office operations, AFMA's 2011 *Operations Survey Report* provides a comprehensive picture of operations functions for financial markets performed in Australia, including the significant challenges facing the industry.

Size or Extent of Use of Permanent Establishments

As noted above, most foreign banks with Australian operations operate through permanent establishments as opposed to subsidiaries. As at October 2012, foreign bank branches held 7.9% of the share of bank assets, which was double that of foreign bank subsidiaries.

Figure 1

Foreign Bank Branch – Market Share of Banking



Note: Market share is measured as foreign bank branch Australian resident assets as a percentage of all banks Australian resident assets – derived from APRA data.

However, the market share of foreign bank branches has fallen by almost half since the onset of the GFC, reversing their balance sheet rapid growth prior to the GFC that had the effect of reducing business loan margins. This is largely due to contraction by European banks, with Japanese and other Asian banks exhibiting significant growth in their balance sheets.

The market share of foreign bank subsidiaries fell largely due to the sale of businesses conducted through these subsidiaries to the major Australian-owned banks.

2 Support for the Functionally Separate Entity Approach

On 13 April 2012, AFMA provided a submission to the Australian Treasury regarding the Exposure Draft for Stage 1 of the Transfer Pricing reforms, as set out in the now enacted Subdivision 815-A of the *Income Tax Assessment Act* 1997 (**the 1997 Act**). In this submission, it was noted that:

> "AFMA supports the prospective alignment of Australia's transfer pricing rules for Australian Banks with outbound investments with international practice, as outlined in the OECD 2010 guidelines. We believe that permanent establishments of both foreign banks with branch operations in Australia and of domestic banks that have offshore branch operations should be taxed on a separate entity basis. This approach is consistent with the principles of tax neutrality and it would be in line with the OECD approach to permanent establishment taxation, which best reflects international best practice."

The basis for AFMA's support for the functionally separate entity approach is that, in our view, such an approach promotes tax efficiency, generally supports tax revenues and reduces both tax risk and compliance costs. This is important to the economy for two reasons:

- Firstly, it helps to promote and maintain a diversified financial system that embodies strong competition forces, through domestic and foreign banks and financial markets that have the operational and financial capability to finance Australian businesses and support investment and economic growth; and
- Secondly, this enhances Australia's global competitiveness and is consistent with the Government's stated aspiration of Australia being a significant global centre for financial services.

Australia has large investment capital flows both into and out of the economy, but is a significant net importer of capital. In practice, bank branches are an important conduit for the transfer of capital between economies. A sound operating environment for branches contributes to the health of the economy in this respect.

Tax rules that are both reasonable and certain are necessary features of an effective environment and this should be the prime focus of the tax reform process. In this context, AFMA's experience with Part IIIB, which adopts the separate entity approach for key business areas of foreign bank branches, has been positive and we support the extension of the functionally separate entity approach to outbound bank branches.

Recent financial system developments are a relevant consideration for the Board in assessing the utility of the current tax rules and proposals for change. In this context, we note that a direct impact of the GFC has been to increase the amount of credit intermediation undertaken through banks, and there has also been increased concentration of lending within the banking sector. This is in part because foreign bank branches had to reduce their financing for Australian business post the GFC.

In relation to the short-term and long-term impacts on taxation revenues, it is AFMA's view that the adoption of a functionally separate entity approach should not give rise to material implications and that any implications should generally be revenue accretive for Australia. From an outbound perspective, we do not believe that the adoption of the functionally separate entity approach would practically alter the approach currently utilised to pricing intra-entity transactions. In practice, banks economically manage risks between branches/head office applying a functionally separate entity approach and prepare their accounts on this basis. However, to the extent that the functionally separate entity approach would permit Australian headquartered entities to recognise income from offshore branches for head office services performed on behalf of the branches, such headquartered entities would have increased Australian taxable income.

One of the key benefits associated with the formal adoption of the functionally separate entity approach in Australia's domestic taxation law and treaty network is to provide requisite certainty to taxpayers as to the appropriate manner for dealing with intra-entity transactions. To date, the lack of clear legislative guidance has led to uncertainty as to the appropriate taxation consequences for intra-entity transactions and associated uncertainty as to whether the views adopted by industry participants aligned with those of the Australian Taxation Office. This issue must be addressed if Australia is to take full advantage of the "Asian Century" growth outlook.

Notwithstanding that the Discussion Paper notes that "countries have not universally adopted the new Article 7, or the relevant commentary" and specifically acknowledges that New Zealand is one country that has entered a reservation to the new Article, it is AFMA's view that adoption of the new Article 7 and, more generally, the functionally separate entity approach will become the international standard. Accordingly, adoption of the approach in Australia's domestic transfer pricing legislation and network of Double Taxation Agreements will minimise the risks of double taxation for taxpayers and ensure that Australia's approach to transfer pricing is consistent with its principal trading partners.

Finally, it is noted that the Australian Treasury has released Exposure Draft legislation and an accompanying Draft Explanatory Memorandum that seeks to ensure that Australia's domestic transfer pricing legislation is interpreted in a manner consistent with the 2010 OECD Transfer Pricing Guidelines. It follows from this approach that, to the extent possible, the domestic legislation should mirror the most recent Transfer Pricing Guidelines, including Article 7. To carve out Article 7 of the Transfer Pricing Guidelines from the domestic law would, in AFMA's view, significantly undermine the legislative approach that has been proposed in draft Subdivisions 815-B and 815-C of the 1997 Act, and will generate significant uncertainty as to the proper interpretation of the new provisions (if enacted).

3 Part IIIB, the LIBOR Cap and the Authorised OECD Approach

Section 8 of the Discussion Paper focusses on Part IIIB of the 1936 Act. We welcome the opportunity to again provide a submission on the continuation and modernisation of Part IIIB.

3.1 Retention, modernisation and expansion of Part IIIB

3.1.1 Retention of Part IIIB

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. Part IIIB is particularly important for foreign banks whose home base is a jurisdiction that does not have a Double Taxation Treaty with Australia.

AFMA notes that to the extent that the functionally separate entity principle is enshrined in both the domestic law and the network of Double Taxation Treaties then Australian branches of foreign banks may well be able to obtain the same level of certainty outside Part IIIB at some point in the future. However, we acknowledge that this may take a considerable period of time and hence support the retention of Part IIIB in the interim.

3.1.2 Modernisation of Part IIIB

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. For example, the 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.

Noting the above, 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. We would welcome a more expansive definition of “derivative transaction” in

Section 160ZZV that would support the full range of potential derivative transactions that could be entered into between the Australian branch and its parent to at least the five classes noted above.

We recommend that a more expansive definition of "derivative transaction" be included in Part IIIB such 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.

3.2 Policy Review Recommendations on the LIBOR Cap

Section 160ZZZA(1)(c) of the 1936 Act caps the deductibility of interest paid by a foreign bank branch on funds borrowed from its parent to LIBOR, known as the "LIBOR Cap." AFMA has made a number of submissions previously to Treasury regarding the extent to which the LIBOR Cap is inconsistent with appropriate competition, regulatory or tax policy and strongly recommends the removal of the LIBOR Cap.

The taxation inequities imposed by the LIBOR Cap have 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.

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.

By way of illustration, the market share of foreign banks has fallen from over 14.6% as at December 2007 to 7.9% as at October 2012. In dollar terms, this equates to a reduction in assets held by foreign banks of AUD$80 billion. The LIBOR Cap is one of several factors that contributed to this outcome.

It is AFMA's submission that the LIBOR Cap is defective tax policy and should be abolished because it reduces competition, is economically harmful, is inequitable and conflicts with internationally accepted transfer pricing norms that rely on arm's length pricing.

3.2.1 Australia as a Financial Services Centre

AFMA has received clear and consistent feedback from its members that the LIBOR Cap makes Australia a less attractive place for foreign banks to conduct business and is an impediment to the stated policy objective of the Federal Government of promoting Australia as a global and regional financial centre. The Discussion Paper acknowledges this point by directly quoting from the Johnson Report, which strongly recommended the removal of the LIBOR Cap.

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.

3.2.2 Basel III Liquidity Reforms

The new liquidity reforms set out under Basel III, which commence operation from 1 January 2013, will serve to exacerbate the issues associated with the LIBOR Cap. This will arise through requiring banks to extend the maturity of funding to periods well beyond twelve months. Given that it is expected that Australian branches of foreign banks will rely on their parent to comply with the Basel III liquidity reforms, such branches will have an increased proportion of parent funding with a maturity in excess of twelve months.

As LIBOR is only available for maturities up to one year, and given that the twelve month LIBOR rate significantly underestimates the cost of funds for periods in excess of twelve months, the proportion of interest that will be treated as non-deductible under the LIBOR cap will increase. Based on data held by AFMA, twelve month LIBOR underestimates the cost of three year funding by up to 120 basis points.

3.2.3 Reduction in Compliance Costs

The LIBOR Cap places a compliance burden on both taxpayers and the Australian Taxation Office by creating an extra layer of tax requirements that require monitoring, documentation and reporting. Foreign banks record the actual cost of borrowing funds from head office in their books for accounting and regulatory purposes and are required to ensure that the funds are provided on an arm's length basis to adhere to transfer pricing requirements, both in Australia (especially for those foreign bank branches that are able to opt out of Part IIIB under Section 160ZZVB(2) of the 1936 Act) and in the head office jurisdiction.

The calculation of the deductible interest under the LIBOR Cap is of no use in either Australia or the head office jurisdiction, except for compliance with Part IIIB. Hence, the LIBOR Cap represents an additional and onerous compliance burden for foreign banks acting through an Australian branch, thereby unnecessarily increasing costs of operating in Australia and reducing competitiveness.

3.3 Responses to Specific Questions in the Discussion Paper

(i) Views on whether Part IIIB is consistent with the KERT and other requirements of the authorised OECD approach (as set out in Chapters 4, 5 and 6 of this Discussion Paper?

By enshrining a functionally separate entity approach to funding transactions, derivative transactions and foreign exchange transactions, Part IIIB is drafted in a manner consistent with the authorised OECD approach, and particularly the KERT. Part IIIB will recognise the key risks undertaken by the Australian branch of the foreign bank and the passing the management of the risk to head office through respecting transactions between the branch and head office. However, as noted above, Part IIIB will need to be modernised to ensure that derivative transactions that manage a broad range of risks are eligible for Part IIIB, as opposed to just interest rate risk and foreign exchange risk.

Section 8.7 of the Discussion Paper states that "the authorised OECD approach requires free capital and debt to be allocated to a branch…having regard to what capital an independent enterprise performing the functions of the branch, using the same assets and assuming the same risks would have after applying the same creditworthiness rule." Hence, to the extent that Part IIIB was to properly reflect the authorised OECD approach, an arm's length allocation of capital would be required. This would be inconsistent with the current drafting of Part IIIB.

As noted in the Draft Explanatory Memorandum to the *Tax Laws Amendment (Cross Border Transfer Pricing) Bill* 2013, Division 820 of the 1997 Act represents a "comprehensive regime" to allocate debt and equity for tax purposes and, accordingly, determine the interest expense that is deductible. To the extent that the Australian Branch of a foreign bank determines its minimum capital amount with reference to Subdivision 820-E of the 1997 Act, then the capital amount so determined should be treated as arm's length capital under Part IIIB. This will ensure competitive neutrality between inward and outward financial institutions to the extent that the existing requirements under Division 820 are consistent.

(ii) *If Part IIIB is not consistent with the requirements of the authorised OECD Approach, how Part IIIB should be amended to facilitate the authorised OECD approach?*

Refer to the comments above.

(iii) *If Part IIIB is retained with a cap on the interest rate that can be charged in notional debt, which international benchmark rate would be the most appropriate and why?*

AFMA submits that Part IIIB should be retained but without a statutory cap on the amount of deductible interest of the branch. The amount of deductible interest for the branch should be calculated on an arm's length basis in accordance with transfer pricing principles. AFMA does not believe that there is any deficiency in the design or operation of the transfer pricing rules that warrants maintenance of either the LIBOR Cap or any other benchmark cap on deductibility of interest.

As noted in the Johnson Report, in an excerpt repeated in the discussion paper, the GFC highlighted the reasons why the LIBOR Cap is a particularly inappropriate benchmark for the deductibility of interest. It is AFMA's contention that any approach that arbitrarily imposes an artificial ceiling on what is deemed to be an arm's length rate is deficient from a policy perspective. Ultimately a bank will satisfy its funding requirements through the issuance of securities with different maturities, currencies and terms in both the short term and long term markets, and the overall cost of funds will fluctuate significantly from one period to the next, let alone from one institution to the next. Accordingly, any tax provision that seeks to generalise the deductibility of interest based on a singular benchmark will be inherently flawed.

Conversely, from a transfer pricing perspective, determining an arm's length rate for a particular institution at a particular point in time should not pose a technically difficult issue for the ATO. There is a high level of price transparency in both the short term and long term debt markets and it is possible to assess the reasonableness of the interest expense claimed with reference to other market transactions and indicators.

(iv) If Part IIIB is retained but the LIBOR Cap is removed, what would be the expected impact on:

- *The level of Australian tax paid on the profits of the Australian branch operations of foreign banks and other qualifying financial entities?*
- *Banking competition?*

Revenue Outcomes

Based on information received from its members, AFMA believes that the removal of the LIBOR Cap would result in an increase to tax revenue.

The revenue base will be protected by the separate entity treatment entrenched in Part IIIB and transfer pricing rules to ensure that transactions between the Australian branch and foreign parent reflect arm's length conditions. Further, for the reasons outlined above, it is expected that the removal of the LIBOR Cap would increase the levels of activity conducted by foreign banks at or through Australian branches and accordingly increase the revenues available to be taxed in Australia. AFMA surveyed its members in 2012 and more than half of the respondents that were subject to interest deduction denial under the LIBOR Cap in 2010/11, 2011/12 or both responded that they would bring business into Australia that was currently being conducted elsewhere if the LIBOR Cap was removed.

The foreign banks most affected by the LIBOR Cap may opt out of Part IIIB to avoid the cap if they are headquartered in a jurisdiction that has a Double Tax Treaty with Australia. However, this comes at a cost of greater tax uncertainty from a transfer pricing perspective and the inability to manage the tax affairs of a group in Australia on a collective basis (such as thin capitalisation grouping and the ability to transfer revenue and capital losses to other group entities).

A conservative analysis shows that the removal of the LIBOR Cap should be revenue positive for the following reasons:

a) Foreign bank branches have stated that removal of the LIBOR Cap would lead them to increase their lending in Australia and bring business into Australia that is currently conducted from overseas;
b) Bank competition generated by the removal of the LIBOR Cap would provide a cost benefit to Australian business of at least $200 million per annum in addition to the billions of dollars of additional credit given to business, thereby sparking greater economic activity; and
c) There is a consensus view amongst foreign bank branches that removal of the LIBOR Cap would increase Australia's competitiveness as an international financial centre, which would generate additional employment, income and tax revenue for the Government.

On the basis of these conservative assumptions, our estimate as to the tax revenue implications for the removal of the LIBOR Cap are summarised in Table 2 below.

Table 2 – Revenue Implications of Removal of LIBOR Cap

	Ongoing (million)	**Explanation**
Revenue benefit		
Foreign branch tax payable	4.2	Assumes a 2% increase in foreign branch business in Australia, margin of 1%, removal of LIBOR Cap and tax rate of 30%
Business tax payable	>10.0	Assumes a five basis point reduction in business loan margins due to competition ($200M + cost saving for business and greater economic activity).
Australia as a financial centre	1.5	Assumes a 2% retention/improvement in base level employment of operations personnel.
Total tax payable	**>15.7**	

Banking Competition

As noted above, the market share of foreign banks has fallen substantially from its pre-GFC level and there has been a reduction in banking competition since the GFC.

Foreign bank branches provide competition in the wholesale banking and financial markets, which benefits Australian business and the broader community, including retail borrowers and investors. Foreign bank branches are the largest lenders to Australian business after the major banks and the main source of competition in this market. The harm to competition is more accentuated in the wholesale market as foreign bank branches heavily concentrate their activities in this market.

The LIBOR Cap has the effect of reducing bank competition – it increases the funding costs for many foreign bank branches, presents a barrier to the free-flow of bank funds and hinders their ability to compete in the business loan market. Some banks have modelled the impact of the LIBOR Cap and report that it has a greater detrimental impact on them than does interest withholding tax on intra-bank funding. A majority of foreign bank branches who are affected by the LIBOR Cap have indicated that their bank would be in a position to increase lending in Australia if the cap was removed.

On the liability side of the balance sheet, foreign ADIs rely more heavily than other banks on the wholesale market, and in particular on the short term money market, to fund their lending books. The amount of bank CDs and bills on issue has fallen by 40% since end-2007 and turnover on the market fell by 37% in the four years to mid-2012. To a significant degree, this reflects banks positioning themselves for implementation of the Basel III liquidity reforms that will no longer treat bank paper as a liquid asset. Accordingly, foreign ADIs will have to look for alternative sources of funding, which necessarily must include parent bank funding given the regulatory restrictions on the branches accepting retail deposits.

Given the shifting pattern in the geographical source of foreign funding for Australian business through foreign bank branches, it is important to note that new entrants into the Australian banking market are likely to be disproportionately affected by the LIBOR Cap, because they do not have established independent funding programs in the early stages and are more reliant on parent bank funding to which the cap applies.

(v) *The methodology (including inputs from market sources) for determining the rates and prices internally charged by foreign banks to their Australian branches, including the circumstances and variables taken into account, for each of the following kinds of internal dealings recorded with respect to the entity's own branch operations and covered by Part IIIB:*

- *Internal funding or "loans" (Australian dollar or foreign currency denominated);*
- *Internal derivatives ((Australian dollar or foreign currency denominated);*
- *Spot foreign currency transactions; and*
- *Other kinds of internal dealings (such as capital assets).*

(vi) *For the above, what would be the outcome if the functional currency is not the Australian dollar? For this situation, please provide examples for financial arrangements in both the functional currency and other than in the functional currency.*

Shortly stated, the methodology applied to determine the rates and prices charged internally by foreign banks in transactions with their Australian branched mirror the pricing and rates for transactions with external counterparties. For funding transactions, generally the pricing is based on the wholesale rates at which the bank could issue floating rate notes for the particular tenor in question. For derivative transactions, foreign exchange transactions and other internal dealings, such dealings are priced using arm's length market rates. There is a wide range of data service providers (including AFMA) that publish pricing data for the significant OTC markets.

It is noted that the functional currency of the internal dealing will generally have no bearing on the methodology applied to price the dealing.

With regard to derivative transactions, we note the current moves by the Australian Treasury to implement Australia's commitment to the G-20 in relation to over the counter derivatives. These commitments "aim to bring transparency to OTC derivatives markets and improve risk management practices[3]" through:

- The reporting of over-the-counter derivatives to trade repositories;
- The clearing of standardised over-the-counter derivatives through central counterparties; and
- The execution of standardised over-the-counter derivatives on exchanges or electronic trading platforms, where appropriate.

[3] "Implementation of Australia's G-20 over-the-counter derivatives commitments" – Treasury Proposals Paper, December 2012

AFMA notes that the implementation of these measures will further improve the transparency of pricing for over-the-counter derivative transactions and make available to revenue authorities such as the Australian Taxation Office a significant amount of data to assist with the benchmarking of the terms of over-the-counter derivative transactions to ensure they are priced at arm's length. In short, the availability of comparable independent transactions is not a reason to avoid the separate entity approach to branch taxation.

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Thank you for the opportunity to comment on the Board's review. Please contact me if you wish to discuss this further.

Yours sincerely

Rob Colquhoun
Director – Policy (Taxation)