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"Bold and Ambitious?"

The 2015 Amendments to the OBU Regime: An Industry Perspective

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1 Overview

> *"I have always felt that Australia should be a bigger financial centre than it is…We have the huge advantage of a gigantic funds management industry – and that is an enormous base upon which to build. We've got strong financial and prudential regulation, and we've got some of the best banks in the world by any measure…The tax system is the biggest set of levers that the government has to incentivise business.*[1]*"*

The Hon. Malcolm Turnbull, October 2015

1.1 Bold and Ambitious

During the course of 2013 and 2014, a number of industry representatives and advisers with a particular interest in Offshore Banking Units (**OBUs**) traipsed back and forth to Canberra to meet with Treasury representatives to discuss the potential reform of the regime. In light of the alarming announcements contained in the 2013-14 Federal Budget, industry proponents had braced themselves to focus on integrity aspects of the regime, and to proffer tailored measures that would address stated integrity concerns without causing significant collateral damage, and thereby jeopardise the ongoing viability of the regime and Australia's attractiveness and potential as a regional financial centre.

However, in a moment long remembered as inspiring optimism that, perhaps, there was the requisite political will not just to tinker with the regime, but to implement enduring reform to place the OBU regime on a competitive footing with similar regimes regionally, the OBU cohort was briefed by the then head of the Corporate and International Tax Division at Treasury. The advice provided was that Treasury had received instructions from the then acting Assistant Treasurer, who had expressed the Government's policy view that the consultation on the reform of the OBU regime be "bold and ambitious." We were asked to consider a new paradigm for the OBU, one that would mirror the best features of counterpart regimes and remove the bugbears that hold back the utilisation of the regime, and hence render its capacity to deliver on its stated policy objectives as sub-optimal.

Industry embraced the comments and the challenge. Significant investment was made in providing Treasury with a clear articulation of what worked in the OBU, what its structural deficiencies were and how the regime could be future-proofed in an era of financial and product innovation.

In the writer's view, the reforms to the OBU regime legislated in 2015 fall a considerable way short of being "bold and ambitious." While most of the reforms are welcomed, and on balance will improve the operation of the OBU regime, such improvements represent maintenance of a regime that is quickly becoming obsolete and continues to be beset with structural inefficiencies. There has not been a material expansion of the activities that are eligible to be undertaken by an OBU, nor any change to how eligibility is determined, the changes to expense allocation and the codification of the 'choice' principle merely reaffirm what was understood to be existing features of the regime and the structure of the regime and its legislative framework remains largely unaltered.

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[1] "Turnbull backs Australia as a financial hub," InvestorDaily, 8 October 2015

Those more optimistic OBU observers like to view the 2015 amendments as a positive first step in an iterative process as opposed to a lost opportunity. The roadmaps to optimisation have been shared and there is currently political rhetoric that is consistent with the promotion of enhancements to Australia's capability as a financial centre. The challenge now is to maintain the momentum and build on the 2015 amendments to develop an OBU reform that is truly "bold and ambitious."

1.2 Structure of the paper

The paper commences by providing some background into the 2015 legislative reforms, concluding that the bulk of the amendments came from either a political imperative to give effect to the recommendations of the 2009 Report by the Australian Financial Centre Forum, officially titled "Australia as a Financial Centre: Building on our Strengths" ("**the Johnson Report**") or as a consequence of refining the reforms announced in the 2013-14 Budget in a manner so as not to threaten the ongoing viability of the OBU regime. The paper then considers the reforms in detail through an industry lens, before setting out the measures that would have represented wholesale improvement to the OBU regime. The paper then considers expected/announced financial innovation and how the developments in the financial services industry would fit within the current and reformed OBU regime.

1.3 Previous papers

The paper assumes familiarity with the operation of the OBU regime in Australia and acknowledges the papers presented at previous conferences, particularly:

- "Offshore Banking Units," *2014 Financial Services Taxation Conference*, Tony Frost, Ultan Macdonald and Craig Marston;
- "OBU Reform Paper," *2011 Financial Services Taxation Conference,* Stephen Southon; and
- "Capturing All Your OBU Activities, *2007 Financial Services Taxation Conference,* Bill Testa.

The writer would also like to express appreciation to Jason Heng, for his OBU paper that is being co-presented and provides an excellent summary of the policy formulation and development of OBUs.

2 Statement of support for the OBU regime

Before considering the specific legislative inclusions and omissions arising from the 2015 legislative amendment process, it is worth reflecting on a recommendation in the Johnson Report that, while on its face appears somewhat aspirational, is actually a crucial aspect of the OBU regime, and the political commitment to it, that results in its significant under-utilisation.

The Johnson Report reflected that the Australian Financial Centre Forum was:

> "struck by the lack of awareness amongst many financial market participants of the objectives and potential benefits of the OBU regime.[2]"

Accordingly, it recommended that:

> "a Government statement of support for and commitment to the regime, in the context of its objective of encouraging a greater flow of cross-border financial transactions to take place through Australia, would be very worthwhile.[3]"

This appears straightforward, and is important in providing the necessary confidence for potential users of OBUs to make the significant initial and ongoing investment to operate an OBU. But the statement has not been forthcoming, nor has any political commitment to the regime above a more general commitment to the reforms of the Johnson Report, as discussed below.

Potential OBU participants have every right to question commitment to the regime from both sides of politics. From the policy position articulated by the Labor party in the run-up to the 2004 Federal Election to abolish the regime were it to win office, through to the reforms announced in the 2013 Federal Budget, under the heading of "closing loopholes in the OBU regime," which would have rendered the OBU regime as inoperable, through to the three year delay between committing to consultation on implementation of the Johnson OBU recommendations to the release of such a paper, observers would understandably be concerned about the extent to which there was real, bipartisan support for the OBU regime. This lack of confidence is as much of a contributor to the under-utilisation of the OBU regime as the many structural flaws in the OBU framework.

In its submission to the Discussion Paper issued by Treasury in 2013, titled "Improving the Offshore Banking Unit Regime" (**the Discussion Paper)**, AFMA stated:

> "(i)n light of the announcements made as part of the 2013-14 Budget, which may be construed as the Government not being supportive of the OBU regime, AFMA believes that a statement of support is both timely and appropriate. Further, we recommend that the Government engage the opposition to ensure that the support for the regime is bipartisan…"

The lack of response to this recommendation gives rise to a continued questioning by potential OBU users as to the commitment to ensure that the regime remains current and competitive. The lack of response also shapes the consultation processes, with an apparent reluctance from Treasury to prioritise the commitment of resources to wholesale reform in the absence of a clearly articulated

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[2] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p61
[3] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p61

political imperative to do so. The author believes that a public statement of commitment and support for the OBU regime from the Government, particularly if on a bipartisan basis, would provide the necessary impetus for continuation of the OBU reform project and also confidence that the regime will remain contemporaneous in light of financial and product innovation.

3 Background to the 2015 OBU Amendments

The legislative changes to the OBU regime, as introduced by the *Tax and Superannuation Laws Amendment (2015 Measures No. 1) Bill* 2015 (**the 2015 legislation**), had two clear and distinct catalysts. Firstly, the political motivation, being a desire by both sides of Federal politics to convey an impression of ownership of the Johnson Report. Secondly, and arguably more importantly from an industry perspective, was engagement between industry and Government regarding the announcements relevant to the OBU regime contained in the 2013-14 Federal Budget which, if implemented as announced, would have threatened the ongoing viability of the OBU regime.

3.1 The Johnson Report

3.1.1 OBU Recommendations

The Johnson Report was delivered by the Australian Financial Centre Forum (**the Forum**), to the then Minister for Financial Services, the Hon. Chris Bowen, in November 2009, having been commissioned more than twelve months prior. The primary stated objective of the Australian Financial Centre Forum was to ensure "that Australia's policy settings allowed the financial sector to take full advantage of business opportunities in the region.[4]"

The Johnson Report made recommendations in relation to 18 distinct policy areas, including the OBU regime. Recommendation 3.2 of the Johnson Report provides[5]:

> "To give full effect to the Government's policy intentions for OBUs, the Forum recommends that:
>
> - The Government, in its response to the Forum's report, include a statement of support for, and commitment to, the OBU regime. Such a statement could refer to arrangements to ensure the ongoing competitiveness of OBUs.
> - The tax uncertainty about 'choice' be removed, if necessary by legislation.
> - Division 9A of the *Income Tax Assessment Act 1936,* which details the list of eligible OBU activities, be updated and regularly reviewed. The Forum's preferred option is for much of the detail in this Division to be replaced with Regulations. Regulations would contain an updated list of eligible OBU activities, developed with advice from Treasury and the ATO, and following consultation from industry. These Regulations would be updated periodically on advice from the proposed Financial Centre Task Force, which would also make periodic recommendations on any other changes to the OBU regime necessary to ensure that it remained internationally competitive[6]..."

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[4] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p5

[5] Ibid, pp61 - 62

[6] There is a further recommendation in relation to streamlining the OBU application process which, is detailed in Jason Heng's paper and is accordingly not elaborated upon further. It is the view of the author that OBU reform resources (both Treasury and industry) would be better expended on other matters.

The basis for these recommendations is also set out in the Johnson Report. With respect to the specific recommendation on the "choice principle," the Report noted that:

> "There is considerable and widespread uncertainty among existing OBU users relating to the issue of whether industry has a "choice" as to whether all OBU-eligible activities have to be treated as OBU transactions. A 1993 determination by the ATO has for many years been interpreted by the industry as meaning that OBU users have a choice in determining whether to book offshore transactions on domestic or offshore (OBU) accounts. In December 2007, the ATO issued a consultation document which suggested it might withdraw this taxation determination, and sought industry reactions…The difficulty for industry is that, having received a number of submissions very critical of the proposal and pointing out its widespread adverse (and presumably unintended) consequences, the ATO has still not clarified its position and has not officially withdrawn or confirmed the 1993 determination. Many existing OBU users informed the Forum that, without the ability to choose whether to book transactions to the OBU or the domestic account, the OBU regime would be unworkable.[7]"

Similarly, the basis for the recommendation in relation to eligible OBU activities was articulated in the Johnson Report, namely:

> "In the face of continued product innovation, the list and descriptions of eligible activities in the tax legislation have become out of date and unclear. As conveyed to the Forum, many potential and actual OBU licensees feel they are trying to fit 'square pegs in round holes.[8]'

In summarising the recommendations in relation to the OBU regime, the Forum stated that it was its "strong view" that implementation of the recommendations would be "likely to yield substantial benefits to Australia, by encouraging a range of financial transactions to take place through Australia that are currently being transacted offshore.[9]" Further, implementation of the recommendations would be "critical to achievement of the Government's objectives and ambitions for Australia's financial sector,[10]" and "have the potential to generate additional taxable income, jobs and benefits to domestic consumers from greater economies of scale and lower fees.[11]"

The importance of these comments cannot be over-stated. The Forum expended considerable time and resources to engage with users and potential users of the OBU regime and to properly unpack the reasons as to why the usage of the regime, and hence the attraction of mobile financial sector activity to Australia, was less than optimal. Once identified, it was incumbent on the Government, if it was truly supportive of the regime, to quickly implement the Johnson recommendations; however this did not occur for some six intervening years. The failure of successive Governments to nimbly implement the recommendations of the Johnson Report, including those pertaining to the OBU regime, resulted in Mark Johnson suggesting, in his submission to the 2015 Financial System Inquiry, that the submission reflects personal experiences working with the Financial Centre Forum and that the submission was

[7] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p58
[8] Ibid, p58
[9] Ibid, p58
[10] Ibid, p58
[11] Ibid, p58

provided on the basis that Mark Johnson would not "wish to be involved in any future initiatives along the line suggested.[12]"

3.1.2 Government Response

The then Labor Government released its response to the Johnson Report in May 2010. In respect of Recommendation 3.2, regarding OBUs, the Government fell short pf providing the statement of support that the Forum had recommended, merely stating that it supported the recommendations "in principle" and would commence a consultation process, beginning with the release of a Discussion Paper covering options for:

- Streamlining the OBU application process;
- Addressing the issue relating to tax uncertainty about "choice"; and
- Ensuring the timely and efficient review of "eligible OBU activities."

The caveated nature of the then Government's "support" is notable for two reasons. Firstly, the Government did not explicitly accept the recommendation from the Johnson Report that there be a statement of support for the OBU regime. As noted above, this has not been subsequently forthcoming, particularly on a bi-partisan basis, which reduces both awareness and confidence in the regime both continuing and maintaining its competitiveness in the region. Given the significant costs, especially start-up costs, associated with establishing and ensuring continued compliance by an OBU, the lack of articulated Government support for the regime renders the extent to which the regime is utilised as sub-optimal.

Secondly, the then Government response did not place a timeframe on the release of the promised Discussion Paper. This Discussion Paper was only finally released in June 2013, some three years after the commitment from the Government to consult and, significantly, after the release of the 2013-14 Federal Budget. It is particularly ironic that one of the recommendations from the Johnson Report that the Government expressed a commitment to was to ensure the "timely and efficient" review of eligible OBU activities, but not even the process to review such activities, let alone the activities themselves, was consulted upon in a timely or efficient manner.

3.1.3 Political Commitment to the Johnson Report

The 2013 Federal Election saw a change of Government, but one that did not derail the OBU consultation process, although it may be open to conclude that there was at least an attempted change of direction. Notwithstanding that the Johnson Report was commissioned by Labor, who remained in Government at the time of the report being released and also at the time of the Government response, the Coalition has also stated its support for the Report and the recommendations contained therein. In its pre-2013 election material, the Coalition stated that it would "give priority to the recommendations of the Johnson Report into Australia as a financial centre.[13]" Hence, there was a political imperative to the implementation of some of the outstanding Johnson recommendations and a desire for the incoming Government to take ownership, politically, of the recommendations. While this is a laudable objective,

[12] Mark Johnson, *"Policy Formulation in Evolving Financial Markets*," Submission to the Financial System Inquiry, 2014, p6
[13] "Our Plan: Real Solutions for All Australians," p30

and indeed one that industry continues to hold the Government accountable to in a variety of ways, the concern is that reforms germane to the development of Australia as a financial centre are viewed through the prism of the Johnson Report and hence, implementation of the Johnson recommendations is seen as fulfilment of the reform of the policy settings to enhance Australia's financial services capability. Given the effluxion of time between the delivery of the Johnson Report and now, this is a dangerous assumption.

3.2 The 2013-14 Budget

The second significant catalyst for the amendments to the OBU regime in the 2015 legislation was the 2013-14 Federal Budget. For industry participants and OBU observers, the 2013 Budget had a number of surprises. Under the particularly inflammatory heading of "Protecting the corporate tax base from erosion and loopholes – closing loopholes in the Offshore Banking Unit regime[14]," the Budget proposed a suite of reforms that would:

- treat dealings with related parties, including the transfer of transactions between an OBU and a related domestic bank, as ineligible;
- treat transactions between OBUs, including between unrelated OBUs, as ineligible for OBU treatment;
- ensure that other provisions of the income tax law interact appropriately with the OBU provisions; and
- "tighten" the current list of eligible OBU activity.

Importantly, these changes were to have effect for income years starting on or after 1 July 2013 which, for OBUs with a 30 June balance date, was a mere seven weeks after the announcement. It was not apparent to industry, at the time of the 2013-14 Budget, how an OBU as to comply with the announcements contained in the Budget given the lack of legislative clarity and some ambiguity as to the ambit of the announced proposals.

3.2.1 Industry Concern

As noted above, shortly after the 2013-14 Budget, Treasury released a Discussion Paper on the implementation of the Budget announcements and also to allow for consultation on the outstanding Johnson recommendations. The AFMA submission to the Discussion Paper made the following points relevant to the Budget announcements:

- Given that financial institutions increasingly adopt business models that centralise risks, such as funding, credit and market risks, a measure that prohibited related party dealings by an OBU would be entirely inconsistent with such models and as such would threaten the ongoing viability of the OBU regime. As such, any integrity concerns that the Government had regarding the operation of the OBU regime arising from related party dealings should be addressed via targeted integrity measures that focus on such concerns as opposed to a broad prohibition; and

[14] Australian Government, *"Budget Paper No. 2"*, 2013-14, p 34

- Transactions between unrelated OBUs enhance liquidity of OBU funding available to be used to conduct eligible OB activities and also allows for larger transactions to be offered by multiple OBUs. Further, allowing dealings between unrelated OBUs acknowledges that some OBUs may conduct specific functions that facilitate other OBUs to enter into transactions with overseas parties. Given the lack of an articulated integrity concern with OBUs transacting with other OBUs, it was recommended that the Government not proceed with the suggested prohibition.

Given its view as to the considerable damage that would be inflicted on the OBU regime and its participants, industry was proactive in engaging with Treasury and the Government to both defer the commencement of operation of the new measures and also to seek a better articulation of the integrity concerns that gave rise to the Budget announcements, so as to allow for the formulation of targeted integrity measures that would allay the integrity concerns while mitigating collateral damage to the regime. These included:

- Codification of the choice principle and ensuring that any change would be irrevocable, apart from in the instance of genuine error;
- Recommending a statutory definition of "trading" and limiting the definition to portfolio interests; and
- Recommending an additional integrity rule to ensure that transactions that interposed a related party for the purpose of converting non-OB income into OB income (or non-OB money into OB money) would not be eligible for OBU treatment[15].

It is worth noting that there was an additional area proposed in the 2013-14 Budget papers for consultation that was neither an integrity issue nor an issue that was raised in the Johnson Report. The Budget Paper states that "(t)he Government will consult with industry to develop recommendations to address concerns with the allocation of expenses between OBU and non-OBU activities." As noted further below, the catalyst for the review of the expense allocation provisions was advice to Treasury from OBU users that the apportionment rule in former Section 121EF gave rise to arbitrary and distorted outcomes, particularly in relation to statutory deductions such as those under Sections 25-90 and 40-880.

Accordingly, the June 2013 Treasury Discussion Paper canvassed the following topics as potential areas of reform of the OBU regime. The basis for their inclusion in the Discussion Paper is also included:

Topic For OBU Reform	Catalyst for Inclusion
Prohibition against related party dealings	2013/14 Federal Budget
The "choice" principle	Johnson Report
List of eligible OB activities	Johnson Report

[15] It is noted that this proposal from industry was ultimately not adopted. The specific proposal was that where a related party was interposed between an OBU and an offshore person for the dominant purpose of turning non OB-income or money into OB-income or money, then the transaction between the OBU and the related party would not be relevant.

Allocation of expenses between OBU and non-OBU	Industry, particularly given s25-90 and s40-880
Streamlining the OBU application process	Johnson Report
Ensuring appropriate interaction with other provisions	2013/14 Federal Budget

4 The 2015 Reforms – Industry Assessment

The formal Treasury consultation process that commenced with the June 2013 Discussion Paper resulted (but hopefully did not conclude with) the legislated amendments to the OBU regime, which received Royal Assent in June 2015. The legislated measures were the subject of a number of rounds of consultation with industry, including through the release of an Exposure Draft and accompanying draft Explanatory Memorandum in March 2015 and also post the introduction of the Bill into the House of Representatives via a Senate Committee process.[16]

4.1 Summary of the legislated amendments

The 2015 reforms essentially follow the topics raised in the 2013 Discussion Paper, although the scope and application of the amendments were refined considerably between 2013 and 2015 through the various consultation processes. The particular amendments, as detailed in the Explanatory Memorandum, were as follows:

- Clarifying the definition of "trading activity" to impose a restriction of a total participation interest in the underlying entity is not more than 10% or is not held "for trading" in accordance with the accounting standards;
- Codification of the "choice" principle, including a particular integrity rule regarding a group of transactions;
- Amending the methodology for the allocation of general expenses;
- Expansion of the list of eligible activities to include:
    - Unfunded commitments;
    - Syndicated lending activities;
    - Guarantee activities, and particularly the circumstances where there is a connection to Australia;
    - Commodities and commodity derivatives trading;
    - Securities lending and repurchase agreements;
    - Non-deliverable forwards;
    - Funds management where the portfolio includes Australian assets;
    - Advice on the disposal of investments; and
    - Leasing activities; and
- Internal financial dealings between an OBU and other parts of the enterprise.

Set out below is a summary of the industry views, as articulated in various submissions, on the proposed amendments.

[16] Refer to the comments in the Senate Economics Committee review into the Tax and Superannuation Laws Amendment (2015 Measures No. 1) Bill 2015, as issued on 15 June 2015.

4.2 Clarifying the definition of "trading" activity

One of the perceived mischiefs that gave rise to the 2013 Budget announcement prohibiting related party dealings by OBUs was a concern that OBUs were "trading" in shares in subsidiaries, which were primarily engaged in activities which themselves would not be eligible OB activities. This would have the effect of converting non-eligible OB income into eligible OB income, that is, the revenues associated with the non-eligible OB activities would be taxed at the concessional OBU tax rate through the interposition of a non-resident subsidiary.

Acknowledging the concern, industry's view was that the deficiency in the OBU framework that gave rise to the concern was not the ability for OBUs to enter into related party transactions but rather the lack of a clear articulation as to what was meant by "trading." The former Section 121ED provided that trading was, in respect of a "thing" where the trader acquires the "thing" or sells the "thing" for the purpose of trading. Hence, as long as one of the "things" was an asset covered by Section 121D(4) and the transaction was entered into with an offshore person, acquisitions for the purpose of trading and disposals could be considered to be trading. Given one of the classes of eligible assets was "securities issued by non-residents," then the acquisition and disposal of shares issued by a non-resident subsidiary could be included as "trading."

AFMA's submission, therefore, was that the articulated integrity concern could be addressed by a targeted integrity measure limiting the ambit of the term "trading activity" with regards to shares in non-resident companies to only portfolio interests (i.e. holdings of less than 10%). As such, AFMA was generally supportive of the conceptual basis for the proposed amendment, particularly on the basis that the Government would not proceed with the prohibition against related party dealings by an OBU[17].

However, industry did express concerns to Treasury through the combined AFMA/ABA submission to the Exposure Draft regarding the precise working of the test. The concerns related to the requirement for a two-pronged test, particularly given that the "participation interest" requirement in the legislation, requiring tracing of indirect interests, is more onerous than the "portfolio" interest test that was submitted by industry. The legislation also is silent on change of intention, i.e. whether an asset that was initially booked in the OBU's accounts as being an investment, but subsequently changed to a trading asset, is one that is capable of falling within the ambit of a trading activity; however the Explanatory Memorandum was amended to include a statement that the relevant test time is "just before the trading activity."

On balance, while the test for establishing whether a transaction meets the definition of "trading" is more cumbersome than that proposed by industry, the legislated measure is acknowledged as being vastly superior to the outright prohibition on related party dealings by an OBU, which was the initial policy response to address the integrity concern.

[17] The Hon Joe Hockey, MP and Senator the Hon. Arthur Sinodinos, AO, *"Restoring Integrity in the Australian Tax System*, 6 November 2013

4.3 The 'choice' principle

Codification of the 'choice' principle was a necessary part of the OBU reforms and was welcomed by industry. As set out in the Johnson Report, the 2007 consultation paper issued by the ATO that called into question the extent to which a choice could be made as to whether an eligible OB activity could be booked to the OBU caused considerably consternation amongst OBU users. Many examples were provided to Treasury and the ATO of transactions where not allowing such a choice would give rise to asymmetric outcomes where one leg of a transaction may be eligible to be undertaken by an OBU but the other is not. Further, industry submitted that identification of the residency of a counterparty may be difficult in some situations, such that the conservative decision may be made to book an otherwise eligible transaction in the DBU. From an industry perspective, the comments from the Commissioner in Taxation Determination TD 93/135[18], provided support that the 'choice' principle was enshrined in the OBU rules, until such time an ATO Discussion Paper expressed a preliminary, but not concluded, view to the contrary.

The codification of the 'choice' principle, through requiring the choice to be made at the time the transaction is booked, and being irrevocable but for an error in booking, also acts as an integrity measure as it restricts the ability of transactions to be allocated to either the OBU or DBU depending on whether the transaction is to give rise to assessable income or an allowable deduction. Consequently there was mutual benefit in codifying the choice to book an eligible transaction in an OBU and the legislative development was therefore welcomed by industry.

The legislative enshrinement of the 'choice' principle came with a sting in the tail. An additional integrity measure, which had not been the subject of prior consultation, was included in the Exposure Draft, with proposed Section 121EAA(3) providing that:

> "(t)he OBU is treated as having chosen…to have a thing (the transaction) done by the OBU not be an OB activity if:
>
> (a) it is reasonable to regard the transaction and one or more other things done by the OBU as constituting a single scheme (within the meaning of the *Income Tax Assessment Act 1997)*; and
> (b) the OBU chooses…to have any of those other things done by the OBU not be an OB activity.

Through subsequent engagement with Treasury, it became clear that this measure was designed to deal with "asymmetric swap" transactions[19] and limit the ability of two transactions that are economically linked to be booked separately into an OBU and a DBU. However, the concern was that the ambit of the proposed integrity measure was considerably broader than purely addressing asymmetric swap transactions, by virtue of the ambiguity existing as to the precise meaning of the term "single scheme." Concerns were raised by industry with respect to:

[18] TD 93/135 - Income tax: Offshore Banking Units - what is the effect of a transaction which falls within the definition of offshore banking activity, which is entered into by the part of an OBU which handles the domestic (as opposed to offshore) activities of the bank and which is accounted for in the domestic books?
[19] Refer to Taxation Determination TD 2010/12 for a description of an asymmetric swap transaction.

- **Umbrella trading agreements:** An agreement with an offshore person that is designed to cover a range of potential transactions, including some which may reference AUD underlyings and would need to be booked to the DBU so as not to give rise to a post-tax mismatch with the acquisition of the physical hedge (which would not be an eligible OB activity);
- **Loan facilities:** Loan facilities that provide for multiple lenders or borrowers within the same client group, including Australian and offshore entities, would need to have the loans booked into the DBU and OBU respectively; and
- **Collateral:** An OBU with a number of transactions with an offshore counterparty may post and receive collateral in respect of those transactions in the OBU, notwithstanding that some of the transactions (such as those that reference AUD underlyings) are booked to the DBU.

Based on consultation, the integrity measure attached to the 'choice' principle in the final Bill was refined and improved, although its precise ambit remains unclear. The grouping provision, as set out above, remains in the law (now as Section 121EAA(4)) but now further clarity is provided in the law as to what constitutes a "single scheme." Section 121EAA(5) states that:

> "For the purposes of subsection (4), whether the transaction and one or more things constitutes a single scheme is a question of fact and degree determined having regard to the following (whichever are applicable):
>
> (a) the nature of the transaction and the other things;
> (b) their terms and conditions (including those relating to any payment or other consideration for them);
> (c) the circumstances surrounding their creation and their proposed exercise or performance (including what can reasonably be seen as the purposes of one or more of the entities involved);
> (d) whether they can be dealt with separately or must be dealt with together;
> (e) normal commercial understandings and practices in relation to them (including whether they are regarded commercially as separate things or as a group or series that forms a whole);
> (f) the objects of this Division."

Given the OBU legislation now contains a "Part IVA-esque" set of factors as to whether more than one transaction constitutes a "single scheme," the Explanatory Memorandum provides insight as to the circumstances where the grouping provisions will apply. While not providing significantly enhanced guidance as to the application and indeed weighting of the various factors, the Explanatory Memorandum does provide the following examples:

- **Asymmetric swap scheme:** The taxpayer must make the same choice in respect of both swaps;
- **Loan facilities:** The creation of the facility, the drawdown of funds for the DBU and the drawdown of funds for the OBU are each separate schemes and do not need to be grouped; and
- **Umbrella trading agreement:** It is not commercial practice to understand OBU and DBU trading activities, and the hedging of those activities, as comprising a single scheme. Hence the transactions do not need to be grouped.

The Explanatory Memorandum further notes that the factors included in Section 121EAA(5) are drawn from the TOFA grouping rules and provides caveated support for taxpayers using the examples in the Explanatory Memorandum to the *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008* in determining whether multiple transactions comprise a single scheme. These examples include:

- A non-AUD loan and a cross-currency swap entered into to hedge the FX exposure arising on the loan should not be grouped as a single arrangement;
- The separate rights attaching to a convertible note (namely a fixed income security and a call option to acquire shares in the issuer) should be grouped as a single arrangement; and
- A normal sale and repurchase agreement should be considered to be a single financial arrangement.

It is clear that the integrity rule is designed to remove the ability of transactions to be entered into that rely or are somehow commercially dependent on the tax rate differential between the OBU and the DBU (or the remainder of the enterprise). However, the structure of the integrity rule and particularly the factors required to be assessed/weighted to determine whether several transactions collectively comprise a single scheme for the purpose of applying the ‘choice’ principle arguably requires an analysis beyond a simple assessment as to whether an asymmetric outcome is a cornerstone of the scheme. It is at least encouraging that the examples submitted by industry as being particularly problematic form the basis of examples in the Explanatory Memorandum.

4.4 Allocation of expenses

A particularly positive aspect of the 2015 amendments was the amendment to how general expenses are to be allocated between the OBU and the remainder of the enterprise. The previous methodology to allocate expenses, being the statutory formula in former Section 121EF(4), had given rise to capricious outcomes for a number of OBUs, particularly after the enactment of various statutory deduction provisions such as Section 25-90 and Section 40-880.

Generally, former Section 121EF(4) provided that any deduction that was not an exclusive-OB deduction or an exclusive non-OB deduction would need to be allocated based on the proportion of “adjusted assessable OB income” to “adjusted total assessable income,” with the adjustments broadly being the removal of interest deductions. In the ordinary course, applying the formula gave rise to distortions where the business conducted by the OBU was materially different to the remainder of the enterprise or where the OBU was in a loss but the enterprise as a whole was not. Further, the formula could only be applied post year end, meaning that the OBU’s cost base could not be calculated in real time, giving rise to uncertainty in the pricing of OBU products and services.

These issues were (significantly) exacerbated by the way the formula applied to statutory deductions. A “general expense,” being one to which the statutory allocation formula applied, was one that was neither an exclusive-OB deduction nor an exclusive non-OB deduction. An exclusive-OB deduction is defined in Section 121EF(3) as “any deduction…that relates exclusively to assessable OB income.” An exclusive non-OB deduction is similarly defined in Section 121EF(6) as relating “exclusively to assessable income that is not assessable OB income.” The requirement that the deduction relates exclusively to assessable income meant that statutory deductions, such as Section 25-90 and 40-880 deductions, that have no nexus to assessable income could not be considered to be either exclusively OB or exclusively non-OB, and hence needed to be included in the statutory formula. This was notwithstanding that such expenses may have had no nexus whatsoever to the business being conducted by the OBU.

The amendments cure these issues by removing the statutory formula and by providing that a general deduction is allocated to the OBU “to the extent that” it relates to OB income[20]. In addition, there is no requirement that the general deduction relates to “assessable OB income,” and hence there is the ability, but not the necessity, to apportion statutory deductions to the extent that they are referable to the business being carried on by the OBU.

4.5 Eligible Activities

4.5.1 Leasing Activity

During the engagement with Government in the consultations following the 2013 Federal Budget, it became apparent that one of the integrity concerns underpinning the announcements in the Budget was the debt financing by an OBU of a wholly-owned offshore subsidiary, which would in turn enter into a leasing transaction with an offshore client. Given that leasing was not an eligible-OB activity, the concern expressed was that the interposition of the subsidiary had the effect of turning non-OB (leasing) income into OB (interest) income. While this may have been true, the view expressed by industry in consultation was that undertaking a leasing activity with an offshore person in respect of a non-Australian asset fell squarely within the policy intent of the OBU regime and hence, as opposed to the implementation of blunt integrity rules that would threaten the ongoing viability of the OBU regime, a preferable approach may be to consider including leasing as an eligible-OB activity. This was ultimately accepted by the Government, as reflected in the Explanatory Memorandum to the *Tax and Superannuation Laws Amendment (2015 Measures No. 1) Bill 2015:*

> “(t)he addition of leasing activities is intended to give greater flexibility to OBUs in recognition of the fact that many leasing arrangements have similar commercial features to existing OB activities, such as lending.[21]”

Section 121DD provides that an “OB leasing activity” is a leasing activity with an offshore person involving offshore property. This is elaborated upon by Section 121DD(2), which provides:

> “Without limiting subsection (1), OB leasing activity includes entering into:
>
> (a) any arrangement (within the meaning of section 51AD) under which a right to use offshore property is granted by an owner to another person; or
> (b) any arrangement (within the meaning of that section) under which a right to use offshore property, being a right derived directly or indirectly from a right mentioned in paragraph (a) in relation to the property, is granted by a person to another person:

[20] Defined in Section 121EDA as being so much of an OBU’s income that is either derived from OB activities or included in the statutory income of the OBU because of such activities.
[21] Explanatory Memorandum to the Tax and Superannuation Laws Amendment (2015 Measures No. 1) Bill 2015, paragraph 3.92

with an offshore person."

Industry was broadly supportive of the statutory construction to include leasing as an eligible activity, particularly the reference to Section 51AD and also the ability for both leases and sub-leases to be included in the definition of OB leasing activity. Further, the Explanatory Memorandum confirms that the OBU may act as either lessor or lessee and that the provision applies to both operating and finance leases[22].

There is, however, one particular issue that remains outstanding and is the subject of continued engagement with both the ATO and Treasury, namely the ability of the OBU to dispose of the OB-leased asset once returned by the lessee and have any income from such a disposal included as OB-income. Industry's submission to the Exposure Draft was that in order for the OBU leasing activity to work in accordance with how commercial leasing businesses operate, it was imperative that the OBU have the ability to dispose of the leased asset. Clarity was sought on this issue, initially in a submission to the Exposure Draft (which remained unanswered) and then through a submission to the Senate Economics Committee, who suggested in the Committee's report to the Bill that "the committee draws the government's attention to the issues raised by AFMA and the ABA regarding leasing activities.[23]" Subsequent to the passage of the Bill through both the House of Representatives and the Senate, industry was advised by Treasury that the Government had approved the Bill on the basis that the disposal of the OB-leased asset was not within the scope of an OB-leasing activity.

This approached begged the fundamental question as to what the OBU could do with the OB-leased asset once returned by the lessee. Based on logic that was not entirely compelling, Treasury offered an opinion that any gain on disposal of the OB-leased asset could be booked in the DBU. This conclusion inferred that, at some point, there would need to be a transfer of the OB-leased asset from the OBU to the DBU, which would *prima facie* not be an eligible OB activity and may also give rise to the receipt of non-OB money in the OBU. Further, and of more concern to Treasury, whether there is a gain or loss from a tax perspective from the disposition of the OB-leased asset will depend on whether the asset's tax written down value exceeds its market value at the time of disposal. In the event that it has been under-depreciated through the term of the lease, such that the tax written down value exceeds the market value, and assuming a disposal at market value, the disposal would give rise to a deductible loss. Based on the Treasury view, this loss would be deductible to the DBU at the corporate tax rate of 30%, even though the lease income (less depreciation deductions through the life of the lease) would have been assessable at the OBU rate of 10%. It was somewhat perplexing to industry that such an asymmetric outcome would be palatable to Treasury and the Government given the efforts undertaken elsewhere in the Bill to eliminate asymmetric outcomes.

While no legislative clarity has, as yet, been forthcoming, industry has engaged with the ATO to determine whether an interpretation that facilitates the disposal of the OB-leased asset is feasible. Such an interpretation would seek to utilise the second limb of the definition of "OB income" in Section 121EDA, which provides that OB income is so much of the OBU's ordinary and statutory income as is derived from OB activities or, relevantly, "included in the statutory income because of such activities." That is, to the extent that the disposal of the OB-leased asset gives rise to "statutory income," such as

[22] Explanatory Memorandum to the Tax and Superannuation Laws Amendment (2015 Measures No. 1) Bill 2015, paragraph 3.93.

[23] Senate Economics Committee Report into the Tax and Superannuation Laws Amendment (2015 Measures No. 1) Bill 2015, 15 June 2015.

a Division 40 balancing adjustment, then such income can be considered to arise "because of" the eligible OB activity, being the leasing activity, and hence may be included as OB income. Industry and the ATO are continuing to liaise with respect to the guidance that can be provided, and particularly whether a safe harbour determined with reference to whether the lease is within the parameters set by Taxation Ruling IT 28[24] is appropriate (and, if so, how to treat leases outside such parameters, particularly due to the residual value requirements). There remain other outstanding issues, including:

- Confirmation that any amounts received on the disposal of the OB-leased asset will be OB-money;
- The application to different regulatory regimes, such as regimes that require that the legal owner of the asset is a resident of the same jurisdiction as the asset, and accordingly the OBU may be the beneficiary of a trust;
- The eligibility from an OBU perspective of selling lease receivables; and
- Sale of leased assets prior to the expiry of the lease, and potential safe harbours.

Clarity is also being sought with respect to the interaction between Division 240 and the OB leasing activity provisions. In this regard, it is notable that the Explanatory Memorandum states that the OB leasing activity "will not apply to hire-purchase arrangements that are recharacterised under Division 240 of the ITAA 1997 as notional sale and loan arrangements. Notional loan arrangements may nevertheless be eligible OB activities under subsection 121D(2).[25]"

The other issue with respect to the scope of OB leasing activity is the requirement that the underlying lease be with respect to "offshore property." This means that the property must not be, in the words of the Explanatory Memorandum, "used to a material extent within Australia." Given the scope of this term was not abundantly clear at the time that the Exposure Draft was released, some helpful examples are provided in the Explanatory Memorandum regarding an aeroplane that spends the majority of its time flying international routes, including flights to and from Australia, not being used "to a material extent in Australia."

Subject to the resolution of the disposal issue, the inclusion and design of the OB leasing activity has been welcomed by industry. The operation of a leasing business with non-resident clients and in respect of non-Australian assets falls squarely within the OBU's policy scope and it is somewhat surprising that leasing has only now been included as an eligible-OB activity. As can be seen from the commentary below, the inclusion of OB leasing activity represents the only material expansion of the list of eligible OB activities, and hence whether by itself this is sufficient to satisfy the recommendation of the Johnson Report is questionable.

4.5.2 Creation of lending facilities/unfunded commitments

A technical amendment was made to Section 121D(2)(b) (relating to a borrowing or lending activity, and specifically lending money) to include the words "or making commitments to lend money." The issue here was that at the time an OBU may make available a line of credit to an offshore person, and receive a fee for the establishment of the line, there may not actually be a borrowing until the time that

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[24] "Leasing arrangements of plant and machinery," 6 July 1960

[25] Explanatory Memorandum to the Tax and Superannuation Laws Amendment (2015 Measures No. 1) Bill 2015, Paragraph 3.95.

the offshore person draws down on the line of credit. Hence, the fees did not necessarily arise by virtue of a borrowing or lending activity. The amendment clarifies that all fees that are received by the OBU arising from the commitment to lend money will be included in OB income and constitute OB money. While helpful, this amendment is viewed as being relatively minor in nature and cures a technical hole in the former provisions as opposed to actually expanding the scope of eligible activities.

4.5.3 Syndicated lending activities

Similarly, a technical insertion was made to Section 121D(2) to allow for an OBU to act as an arranger in a syndicated lending arrangement, to the extent that the lending arrangement satisfies the other requirements for a borrowing or lending activity in Section 121D(2) (i.e. with an offshore person and potentially not AUD in certain circumstances).

The interesting point here is that Section 121D(3), regarding a "guarantee-type activity" already included "syndicating a loan for an offshore person." It is not abundantly clear as to the activities that will be covered by new Section 121D(2)(e) that are outside the existing 121D(3)(c) definition; however it is clear that participation in a syndicated loan to an offshore person, including arranging, lending and underwriting of the loan, should be included as an eligible OB activity.

4.5.4 Guarantee activities

The amendment to Section 121D(3), regarding guarantee activities, was not to expand the scope of activities but rather to relax the restrictions as to what activities are permissible to be conducted by an OBU. Under the previous drafting, the OBU eligibility would only arise where the guaranteed property was located outside of Australia and the events could only happen outside Australia. This strict requirement created uncertainty where there was a very small likelihood that either the guaranteed property would at some point be in Australia or alternately the guaranteed event could occur in Australia. Hence the requirement was relaxed such that the guarantee activity does not relate to Australia "to a material extent." As per the comments above in relation to the similar requirements for a leasing activity, the plane example is equally applicable to the ambit of "material extent" in a guarantee activity context.

4.5.5 Trading in commodities or entering into commodity derivatives

Another technical amendment was made to the definition of trading activity in relation to commodities. For reasons that are not abundantly clear, the list of commodities that can be traded as an eligible OB activity is restricted to gold, silver, platinum or palladium bullion and not other commodities. The amendment allows for the trading of additional classes of commodity, where the trading is "incidental to an OB eligible contract activity," that is, for example, where the trading is undertaken to hedge a derivative contract issued by the OBU to an offshore person.

While the amendment is welcome, it does beg two fundamental questions regarding the design of the OBU regime. Firstly, there does not appear to be a compelling reason from a policy perspective as to why an OBU can only trade in some commodities and not others, and hence an amendment that utilises a principles-based definition of commodity would appear preferable from a legislative design perspective. Secondly, the amendment highlights the restrictive nature of the scope of "hedging activity" in Section 121D(8), which only allows hedging of interest rate and currency exposures. That is, to the extent that Section 121D(8) was drafted more broadly, and ideally in a principles-based fashion, this amendment would not have been required. This is elaborated upon further below.

4.5.6 Securities lending and repurchase agreements

The technical issue arising with respect to securities lending and repurchase agreements (repos) is that, while they are commercially considered to be collateralised loans, and hence from a commercial perspective would be thought of as being consistent with a borrowing or lending activity, their legal form is as a disposal with a commitment to reacquire at a point in the future. Given the commitment to reacquire the asset that is the subject of the repo or securities lending transaction at the time of the disposal, it has historically been difficult to characterise the transactions as being a trading activity. Hence, while securities lending and repo transactions are entirely consistent with the operations of OBUs, particularly those that are financial institutions, it has never been entirely clear as to the appropriate activity that such transactions fall within. The amendment, through including securities lending and repo transactions as “eligible contracts,” helpfully clarifies the position.

One notable feature of the clarification of the OBU eligibility of securities lending and repo transactions is that the terms are not defined and rather take their ordinary commercial meaning. It is industry’s view that given the commercial prevalence of these transactions and the way in which they are documented, whether transactions are within the scope of the terms securities lending or repurchase is clear and does not require statutory clarity. The approach is particularly welcome with respect to securities lending agreements given the statutory definition of such agreements, as contained in Section 26BC of the 1936 Act.

4.5.7 Funds management

There were two legislative amendments to the ability of an OBU to manage funds on behalf of an offshore client, and both are considered to be of assistance to enhancing Australia’s potential to export its financial services capability.

The first, and arguably more narrow, amendment confirms that where an OBU is giving investment advice, this includes advice in relation to the disposal of the asset, regardless of the location of the investment. This may be contrasted with the requirement with respect to the making of an investment, which generally requires that the investment is non-Australian.

The broader amendment is to remove the previous requirement that where Australian assets were being managed by an OBU on behalf of an offshore person, the percentage of such Australian assets could not exceed 10% by value, with the (somewhat draconian) outcome that where the average Australian asset percentage exceeded 10%, none of the fee income received in respect of the funds management qualified for the OBU concession.

The new mechanism, contained in Section 121EE(3A) is to apportion the management fees derived by the OBU between OB-income and non-OB income based on the average percentage of Australian assets. This allows, therefore, for an OBU to make the most appropriate investment decisions for the offshore client without the concern of “blowing up” the OBU treatment based on a higher than 10%

concentration of Australian assets. Further, it removes the risk of technical breaches through changes to asset valuations.

This change is particularly positive, and has been welcomed by the funds management industry. It is consistent with the Investment Manager Regime, which provides requisite tax certainty in respect of the underlying fund, and provides an attractive mechanism to enhance Australia's funds management export capability. This is important at a time that Australia is seeking to remove barriers to exporting financial services[26]. However, as noted below, in order to properly capitalise on the opportunity to enhance Australia's financial services export capability, it would be appropriate to consider other services that commercially are provided by a funds management industry, including custodial and settlement services.

4.5.8 Non-deliverable forwards

The final amendment is technical in nature and is clarification that a non-deliverable forward foreign currency exchange contract (**NDF**) is permissible to be traded by an OBU with any person (as opposed to just an offshore person). The issue that was cured here was that NDFs do not give rise to rights in respect of foreign currency, and hence otherwise do not fit into the existing currency trading eligibility. Unlike the other currency trading provisions, however, there is no currency or counterparty restrictions, meaning that trading in NDFs that can be settled in AUD can be traded with any person.

4.6 Internal financial dealings of an OBU

The last, and somewhat surprising, amendment included in the 2015 legislation was the insertion of an arm's length requirement in Section 121EB. Broadly, the requirement is that in determining the assessable income or allowable deductions of an OBU where the OBU is dealing with another part of the enterprise, there is an assumption that the OBU is dealing at arm's length. This is further clarified (at industry's suggestion) as being determined in a manner consistent with the transfer pricing provisions in Division 815 of the 1997 Act.

This measure was not the subject of consultation before the Exposure Draft and given that transactions between branches are already subject to the transfer pricing provisions in Division 815 of the 1997 Act, it was not, and continues not to be, abundantly clear as to why there is a need for the legislative amendment. The Explanatory Memorandum does not shed significant light on the issue – it merely states that:

> "an OBU may source funding internally from another branch of the same entity…because of the scope of this rule, there are gaps in the application of Australia's transfer pricing rules to an OBU's internal dealings."

Regardless of the basis for the inclusion of the measure, it has not been vehemently objected to by industry, particularly given the clarification of consistency with Division 815. There are some notable aspects to the measure, however. Firstly, it only imposes the arm's length requirement with respect to

[26] This topic is considered more deeply by the Research Report from the Productivity Commission titled "*Barriers to Growth in Service Exports,*" 2015

internal dealings within an enterprise as opposed to related separate entities. Given the view expressed that there are gaps in the application of the transfer pricing principles to OBUs, then there would still appear to be a gap where an OBU deals with a related party that is a distinct legal entity.

Secondly, by acknowledging that an OBU forms part of a multinational enterprise operating in a number of jurisdictions, and by applying the transfer pricing provisions to the OBU on a standalone basis (as opposed to the enterprise of which the OBU forms a part), the amendment acknowledges the appropriate way of determining the appropriate profits referable to the Australian operations, and indeed the OBU, is through a functional analysis consistent with that required under Division 815 and/or Article 7 of a Double Taxation Agreement. This approach would support the removal of current Section 121EA, which includes the requirement for OBU eligibility that the “thing” be “done” in Australia in order for it to be eligible for OBU treatment.

Lastly, on a similar theme, the requirement that the OBU engage in dealings with other parts of the enterprise and (if expanded) other related parties at arm’s length would also provide further justification for the removal of the OB-money rules and the purity test. Such rules require, broadly, that the OBU maintain a separate pool of money with which to conduct activities, comprised of eligible borrowings, paid up capital and retained earnings. To the extent that the OB-money rules assist in the appropriate allocation of income and expenses between the OBU and the other parts of the enterprise (and this is not abundantly clear) then there would appear to be considerable overlap with the new arm’s length requirement.

5 What was missing – enduring reform of the OBU regime

The 2015 amendments to the OBU regime, primarily served three purposes:

(i) To implement (some of) the recommendations of the Johnson Report;
(ii) To enhance integrity as to the operation of the OBU regime in manners different to the proposals set out in the 2013/14 Federal Budget; and
(iii) To make some technical amendments to clarify existing ambiguities or anomalous outcomes.

Through the lens of these three objectives, the 2015 amendments, on balance, improve the operation of the OBU regime. However, given the imprimatur to be "bold and ambitious" by Treasury, a significant number of additional proposals and perspectives were provided through the consultation process, without actually materialising in the amendments. These are set out below, as are comments as to why the reforms would significantly improve the operation and attractiveness of the OBU regime without either expanding the ambit of the regime beyond its policy intent or giving rise to significant integrity/revenue issues.

5.1 Eligible activities – principles based drafting

One of the continued bugbears of the OBU regime is the "laundry list" approach to determining the activities which are eligible to be conducted by an OBU. Not only is there a lack of a coherent policy framework as to what activities are included (as evidenced by the commodity trading issue set out above), more importantly there is insufficient rigour or discipline to ensure that the list of eligible activities remains current in light of financial innovation and development. This was highlighted by Frost, Macdonald and Marston in 2014, who noted that the Singapore Financial Sector Incentive (FSI) regime had been amended in terms of eligible activities five times since 2004[27], as opposed to the OBU regime not being touched, from a legislative perspective, between 1999 and 2015.

With respect to the Johnson recommendation regarding a regulation making power[28], the author is not convinced that there is any enhancement in terms of process with respect to regulations than there is to legislation. While it may be the case that, once an amendment to eligibility is determined by Government to be appropriate then the regulation path may be one of lesser resistance when compared to the legislative path, as has been the Singaporean experience,[29] the challenge that has been faced by industry has been to engage effectively with Treasury to generate the necessary impetus to make revision of the list of eligible OB activities a priority. The three years between the commitment by the

[27] Frost, Macdonald and Marston, *"Offshore Banking Units,"* Tax Institute of Australia, 2014 Financial Services Taxation Conference, p32.
[28] The author notes the existence of this power in Section 121D(1)(h).
[29] The power to amend the Singapore FSI regime sits solely with the Minister for Finance, as opposed to the Parliament through either regulation or legislation.

Government to provide a "timely and efficient" updating of eligible activities and the release of the Treasury Discussion Paper provides clear evidence of this proposition.

Further on the Johnson recommendation regarding eligible activities, a second aspect to the recommendation was that the Regulations would be made on advice from the proposed "Financial Centre Task Force," which was, according to Mark Johnson, "officially wound up in November 2013 but in effect ceased to operate well before that due to lack of funding.[30]" Hence, the body recommended by the Johnson Report as potentially providing the rigour to ensure that the list of eligible OB activities is up to date itself no longer exists.

Hence, absent a formal consultation process initiated by Treasury, there is not a clear mechanism for industry to escalate necessary amendments to the list of eligible activities, and previous efforts to provide such amendments on an unsolicited basis have not yielded any traction in terms of legislative amendment.

In the absence of such rigour, industry has alternatives which would allow the OBU tests for eligibility to be determined on a more principles basis and/or be pegged to other relevant legislation which has a track record of being updated and remaining current and contemporaneous. If these suggestions are not to be accepted, then it the author's view that it is incumbent on the Government to articulate how the regime is to be kept current, including how industry is able to make recommendations as to new eligible activities, such as through re-establishing and properly resourcing the Financial Centre Task Force or tasking other bodies, such as the Board of Taxation or the panel that conducted the 2015 Financial System Inquiry, with a periodic review function.

5.1.1 Division 230 financial arrangement

The first initiative proposed by industry was to support a provision that all transactions with offshore persons (including other OBUs) in respect of a "financial arrangement", as defined in Division 230 of the 1997 Act, are eligible to be conducted by an OBU, subject to a modification in relation to leasing which would be to disregard the operation of Section 230-460, which carves out leasing and hire purchase transactions from the TOFA regime. Specifically, this would include as eligible to be conducted by an OBU:

- All debt instruments, covering both the provision of finance and the funding of such activities;
- All derivative transactions;
- Equity interests that are held for trading purposes; and
- Commodities that are held for trading purposes.

Such an approach would, based on the current regime, largely cover borrowing/lending activities, trading activities, eligible contract activities and hedging activities. Hence, the view of industry was, in respect of transactions undertaken by an OBU, the adoption of the modified Division 230 approach would not materially expand the eligibility of activities vis-à-vis the current regime, but would rather introduce "statutory shorthand" for the current regime based in principles. This would both aid in future proofing the OBU regime and also provide synergies with other legislative provisions that are relevant to organisations that generally operate an OBU. That is, most OBUs would need to understand and

[30] Mark Johnson, "Policy Formulation in Evolving Financial Markets – Submission to the Financial System Inquiry," p3

apply the Division 230 definition of “financial arrangement” for income tax purposes, meaning that there would not be significant duplication of effort in determining OBU eligibility.

5.1.2 Financial services

Given that the “financial arrangement” definition primarily addresses transactions undertaken by the OBU, the additional principles-based mechanism suggested by industry to address services provided by OBUs was to consider the definition of “financial service” in Section 766A of the *Corporations Act.* It was submitted that this definition would cover the existing services eligible to be provided by an OBU and would do so in a way that is readily understood from a commercial perspective. The approach would have the advantage of dovetailing with the issues that foreign institutions that are looking to establish in Australia (and obtain an Australian Financial Services Licence) would be addressing from a regulatory perspective.

The primary issue that has been encountered with respect to importing the *Corporations Act* definition of “financial service” into the OBU framework is that such services are provided with respect to “financial products,” which is defined to include general insurance and life insurance. Providing advice to an offshore person with respect to such insurance products is currently outside the ambit of the regime and hence adoption of the “financial service” definition, without modification, would appear to be a material expansion of the OBU regime. Treasury has indicated that, at least currently, it has no firm view that expanding the OBU regime to include advice on insurance is within policy scope. This should be contrasted with the approach in both Taiwan and Singapore, which actively promote the provision of insurance services within their equivalent regimes. Taiwan has created a specific regime, referred to as “Offshore Insurance Units,” to provide insurance products to offshore customers, while the Singapore regime specifically includes within the “Headquarter Services” Award a number of services relating to insurance[31]. Some commentators have noted, in the Taiwanese context, the addition of insurance as rendering their scheme “more systematic and comprehensive to cover three main financial sectors: banking, securities and insurance.[32]”

5.1.3 Principles to supplement existing framework

An important aspect of the industry submission to introduce principles-based drafting as tests for eligibility is that such principles should be considered in addition, and not as a replacement to, the existing list of eligible OB activities. This is important as it would allow for continued reliance on the considerable body of guidance (both private and public) that has been issued by the ATO in respect of the operation of the OBU regime.

Ultimately, what industry is seeking through aligning the OBU eligibility to the TOFA and *Corporations Act* definitions is to impose the requisite rigour and discipline around ensuring there is a “timely and efficient” review as to eligibility. There are existing tools within the OBU framework to allow for such review to occur but, frankly, they have not been successful. Given industry’s view that adopting the

[31] Including claims management and processing services; loss adjusting services; policy issuance, processing, renewal and collection services; risk-modelling and related services; and run-off management and related services.

[32] Robin Chang, *“New Developments in Offshore Financing (OBUs, OSUs, OIUs) Regime in Taiwan”*, Global Banking and Financial Policy Review, 2014/15, p4

TOFA and *Corporations Act* definitions may not materially expand the ambit of the regime (subject to the resolution of the insurance policy question noted above) but are expected to be updated in line with financial and product innovation, then such an approach mitigates the risk of the OBU regime becoming increasingly obsolete.

5.2 Expansion of existing list of eligible OB activities

Given that the tests for OBU eligibility remain enshrined in the Section 121D laundry list, there are a number of proposals to improve the structure and ambit of the list that were proposed by industry that were not ultimately reflected in the 2015 amendments. These are set out below.

5.2.1 Custodial and settlement services

Throughout the consultation process, industry submitted that the current OBU regime does not cater adequately for the provision of custodial and settlement services. The fundamental issue from industry's perspective is that an OBU, in order to be competitive, needs to be able to offer services at all stages of the transaction lifecycle, namely from the introduction of the transaction through execution, settlement and then custody. Where eligibility is only in respect of a sub-set of the transaction life cycle, this introduces inefficiencies and frictions in the customer offering by virtue of needing to provide services from essentially two distinct entities (OBU and DBU/another part of the enterprise). This is particularly important given that custodians routinely provide other services that are currently within the scope of the OBU regime, including foreign currency services, cash/collateral management and securities lending.

The contention from industry is that the current drafting of OBU eligibility for custodial and settlement services, by requiring that they be conducted only in the context of providing portfolio management services and requiring the custodian also "manages" the investment, is unduly restrictive. Custodians generally provide services to managers as opposed to managing the investments themselves, and hence a standalone custodian is precluded, under the current drafting, from operating through an OBU. The inability to offer a full suite of transactions therefore incentivises those enterprises to operate in jurisdictions outside of Australia.

Given the total assets in custody in Australia (c.$2.8 trillion[33]) exceeds both the market capitalisation of the Australian Securities Exchange and also the total pool of Australian superannuation assets, Australia should be wary from a policy perspective of excluding custodial services from a regime designed to attract mobile financial activity, particularly at a time when Australia is seeking to enhance its capability to export financial services. It is particularly ironic that the clarifications that were sought in respect of custodial and depositary services were not accepted while the clarifications with respect to securities lending and repurchase transactions were adopted, given the core role that custodians play for their clients in engaging in securities lending and repurchase transactions.

[33] Based on statistics provided by the Australian Custodial Securities Association, at http://acsa.com.au/?page=AUSCustody

5.2.2 Hedging activities

As currently drafted, Section 121D(8) only extends the ambit of “hedging activity” to address interest rate and currency risks in respect of borrowing or lending activities. This causes considerable issues where OBUs enter into eligible contracts which may expose the OBUs to other risks, such as equity risk or credit risk, or where the risks being hedged arise from activities which are not borrowing or lending activities. This issue was the basis for the amendments to commodity trading noted above (but not expanded to other classes of risk). Accordingly, industry has submitted that Section 121D(8) be updated to reflect other commercial risks that may arise for an OBU, either through specifying these risks or, preferably, through adopting a drafting construction that any activity undertaken with an offshore person to hedge an exposure arising from the undertaking of another eligible activity is itself eligible to be conducted by an OBU. Such a construction could draw on a similar approach reflected in Division 230.

5.3 OB-money and the purity test

One glaring omission from the 2015 legislation, and indeed through the consultation process (notwithstanding industry’s attempts) was to reform the current OB-money and purity test provisions. Broadly, these provisions require that in order for an activity to be done by the OBU to be eligible, it must be funded through OB-money[34], which broadly comprises an OBU’s paid up capital, retained earnings and money received through conducting eligible OB activities. An excessive use of non-OB money, i.e. where more than 10% of what would be the OBU’s assessable OB income arises through the deployment of non-OB money, will result in a loss of the OBU concession for the entire year of income (the so called “purity test”).

The policy underpinning the OB-money and purity test provisions is not abundantly clear. However, the provisions appear to have their genesis in ensuring that only “pure banking” activities were being undertaken by the OBU, i.e. the OBU intermediating between lender and borrower and deriving an interest margin. This is evidenced by the “One Nation” statement from the then Prime Minister in 1992, preceding the introduction of the current OBU provisions, which noted that the structure of the provisions:

> “recognises the unique character of offshore banking as a highly specialised activity distinct from the core business of the banking sector. As such, the concession will be strictly limited to offshore banking.[35]”

However, given the significant expansion in policy scope of the OBU regime beyond “pure banking” to include trading and funds management in 1999[36], arguably the OB-money and purity test provisions were made redundant at that time.

It remains industry’s contention that the OB-money rules are difficult to apply in practice and impose upon OBUs a significant compliance burden associated with tracking and tracing funds, notwithstanding

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[34] Technically, not “non-OB money.”

[35] *“One Nation,”* Statement by the Hon. P. J. Keating, 26 February 1992.

[36] For a summary of the 1999 amendments and the policy development, please refer to Stephen Southon’s paper *“OBU Reform”* from the 2011 Financial Services Tax Conference.

the inherent fungibility of money. These rules, therefore, impede on the attractiveness and competitiveness of the OBU rules when compared to other regimes in the region. Such inefficiencies are disproportionately burdensome on smaller entities and therefore stymie the utilisation of the OBU regime by smaller organisations.

As noted above, the inclusion in the 2015 amendments of the requirement that the internal dealings of an OBU be at arm's length should bolster the case for the removal of the OB-money requirements, as these provisions will themselves ensure that the income derived and expenses incurred are on an arm's length basis and hence mitigate the opportunity for inappropriate overstating of income or understating of expenses referable to the OBU. It is the author's view that expanding this arm's length requirement, for example to address inter-entity dealings by an OBU, would be laudable to the extent that it justified the removal of the OB-money and purity test provisions.

5.4 The thing is done in Australia

A further recurring inefficiency with the OBU framework which may be cured by the 2015 amendments requiring that the internal dealings of an OBU be at arm's length is the requirement in Section 121EA that the OBU "thing" be "done" in Australia. Specifically, the section requires that:

> "(f)or a thing done by an OBU to be an OB activity, it is necessary that, when the thing is done:
>
> (a) the OBU is a resident and the thing is not done in carrying on a business in a country outside Australia at or through a permanent establishment of the OBU; or
> (b) the OBU is a non-resident and the thing is done in carrying on a business in Australia at or through a permanent establishment of the OBU."

In practice, this section has led to the creation of structures that ensure that the "final act" in terms of a transaction being reflected on the OBU's balance sheet occurs in Australia. In addition, to the extent that the involvement of personnel is located outside of Australia is necessary before an OBU transaction can occur, such as credit approval, there is an element of concern that the requirement of Section 121EA may not be satisfied. This can be increasingly problematic as multinational enterprises look to centralise certain functions, including approvals functions. Trading models that see the book being passed between a number of jurisdictions to facilitate 24 hour trading, as well as those that have the OBU provide binding orders to be executed offshore, also sit uneasily with the Section 121EA requirement.

The Section 121EA requirement is, as an example, at odds with the application of Section 23AH, which merely requires that income *derived by a* foreign branch is non-assessable, non-exempt income. There is no requirement that the "thing" be "done" by the foreign branch and rather the amount attributed to the foreign branch based on a functional analysis will be the amount subject to the exemption.

Given the recently introduced requirement that the internal dealings of an OBU are at arm's length in accordance with transfer pricing principles, and given the advancements in business and trading models that are adopted by multinational institutions, a preferable approach would be to remove the Section 121EA requirement and instead allow for the amount attributed to the OBU based on a functional analysis to be the amount that is subject to the concessional tax rate. Again, as per the comment above with respect to the OB-money and purity test provisions, it is the author's view that ensuring that the

OBU arm's length requirements are sufficiently rigorous to justify the removal of Section 121EA would be a significant enhancement to the operation of the OBU regime.

5.5 Foreign income tax offsets

Foreign withholding tax and other foreign taxes borne by an OBU are automatically subject to a two-thirds write-off as non-claimable under the Foreign Income Tax Offset (**FITO**) provisions. Specifically, Section 121EG(3A) provides that only the "eligible fraction" of each amount of foreign tax is deemed to have been paid by the OBU, with the eligible fraction being the OBU rate of 10% divided by the corporate tax rate of 30%.

This provision leads to a significant disadvantage for OBUs with respect to counterparties that operate in competitor jurisdictions that generally are able to recover foreign tax borne and be relieved from foreign tax. Depending on the business model adopted by the OBU, the inability to obtain relief for two-thirds of the foreign tax borne may lead to extreme effective tax rates, well over 30%, by virtue of the fact that many foreign taxes are imposed upon gross flows as opposed to profit or taxable income. The provision gives rise to arbitrary outcomes that are driven purely by the rate of overseas tax and not the economics of particular transactions from an OBU perspective. Conceptually, the provision is at odds with other regimes that provide concessional corporate tax treatment but full recoverability of FITOs, such as complying superannuation entities.

As an example, an OBU which enters into a total return swap with an offshore person referencing foreign equities will generally hold the basket of foreign equities as a hedge. Under the terms of the swap, the OBU may agree to pay the counterparty a percentage (say 95%) of all dividends paid by the securities in the reference parcel. Say the underlying securities are located in a jurisdiction that has a 15% dividend withholding tax. This would mean that the OBU would receive 85% of the cash dividend and, by virtue of the application of Section 121EG(3A), would only be entitled to claim up to 5% of the amount withheld, subject to capacity. Hence, the OBU would make a loss on the transaction due to the obligation to pay 95% of the cash amount of the dividend and receive value for only 90% (85% cash and 5% foreign income tax offset). To highlight the arbitrariness of the provisions, this loss would be trebled if the withholding rate was 30% and not 15%.

Industry has long maintained that the ability for an OBU to claim foreign income tax offsets be a function of the taxable income earned by the OBU and not on the gross flows that are usually the basis upon which foreign tax is levied. Notwithstanding industry's persistence in raising the issue, and the reference in the OBU Discussion Paper to ensure appropriate interaction with other provisions, this issue has not gained any real traction in recent consultations.

6 Fit for the future? How will the OBU regime cope with financial innovation?

6.1 Introduction

This Chapter considers the robustness of the OBU regime to cope with potential and real innovation in the financial services landscape. As the landscape continues to innovate, in terms of the participants in the sector, the products being offered and the manner in which transactions are effected, the rigid nature of the current OBU framework has the potential to exacerbate the obsolescence of the regime.

The object of this section is to highlight the areas of potential obsolescence and also to consider how the additional reforms proposed by industry, and articulated above, may assist with future-proofing the regime in a manner that allows it to support its stated policy intent.

6.2 Innovative structures and transactions

6.2.1 Algorithmic trading

Algorithmic trading, or high-frequency trading, is an ever-increasing phenomenon in global financial markets. Broadly, it refers to the utilisation of advanced mathematical models for making transaction decisions in the financial markets. According to the International Organization of Securities Commissions (**IOSCO**), the following features can be seen in algorithmic trading models:

- the use of sophisticated technological tools for pursuing a number of different strategies, ranging from market making to arbitrage; and
- a quantitative tool that employs algorithms across the investment chain, including deployment of trading strategies and execution of trades.[37]

In a speech made by the Managing Director of the Monetary Authority of Singapore, Mr Ravi Menon, it was noted that one of the areas of innovation and development in the financial industry included:

> "(i)n equity, commodity and FX markets, some traders are using self-learning algorithms (that) not only analyse historical data, predict price movements and make trading decisions, but continually upgrade and adjust their trading strategies in the light of new evidence and market reactions.[38]"

[37] Technical Committee of IOSCO, *Regulatory issues raised by the impact of technological changes on market integrity and efficiency,* final report, July 2011.

[38] Mr Ravi Menon, *"A Smart Financial Centre"*, Global Technology Law Conference, 29 June 2015.

Such algorithms can clearly trade in respect of underlyings that are OBU-eligible, and hence to the extent that the trading decisions were being made by a person in Australia, then they would be *prima facie* eligible to be conducted by the OBU.

The issue from a future innovation perspective is, in the author's view, the Section 121EA requirement, i.e. the requirement that the "thing" be "done" in Australia. Algorithmic trading, through automation of the manner in which transactions are affected, alters the traditional way in which the Section 121EA requirement may be satisfied, i.e. through pointing to a person in Australia that undertook the trading activity. The question is whether the requirement would be satisfied where the final step in a trading transaction is performed by a program upon which the algorithm is being run, particularly where the trading decisions are automated through the program. As noted above, the Section requires that "for a thing done" by an OBU, it will need to be done in Australia, with the "thing" being an eligible OB activity. On the basis that the setting of the parameters of the algorithm is fundamental to the trading activity, the Section 121EA requirement should be satisfied in these circumstances. However with increasing advances in technology, including the potential for "self-teaching" algorithms, there may be a point in the future where the section 121EA requirement applies less neatly.

A review of published guidance (both public guidance and sanitised Private Binding Rulings) from the Commissioner in respect of the ambit of Section 121EA does not yield significant guidance, with generally an assumption that the requirement is satisfied. Accordingly, given enhanced automation of functions and increased centralisation of certain functions in multinational enterprises, the scope of this provision may be ripe for enhanced ATO guidance. Further, and preferably, the removal of the Section 121EA requirement and determination of the income and expenses attributable to the OBU based on the arm's length requirement would see the activities performed in Australia being properly remunerated (and taxed) without hindering innovation and efficiency in terms of trading operation.

6.2.2 Bitcoin transactions

Bitcoin, and other digital currency, is defined as:

> "a digital representation of value that can be digitally traded and functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value.[39]"

Such currencies may be convertible from digital currencies into real currencies and hence allow for transactions that occur in cyberspace that are settled by bitcoin and other digital currencies to be converted to existing currencies, both AUD and otherwise. The stated primary benefits associated with bitcoin and other similar digital currencies are speed and cost; that is,

> "the speed of VC (virtual currency) based financial transactions is higher than traditional financial asset transfers and takes place within a couple of hours at most. The cost of transactions seems to be currently somewhere around a couple of Euro cents.[40]"

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[39] Senate Economics References Committee, *"Digital currency – game changer or bit player,"* 2015, p3 citing FATF, *"Virtual Currencies – Key Definitions and Potential AML/CTF Risks*" 2014, p4.

[40] The European Securities and Markets Authority, *"Call for evidence, Investment using virtual currency or distributed ledger technology,"* 2015, pp34.

Digital currencies as a medium for effecting settlement of transactions, together with the technology which underpins such currencies (referred to as "blockchain" and elaborated upon below), are a focus of current financial innovation and will, in the author's view, increase in terms of prevalence for capital market transactions.

In terms of assessing eligibility for bitcoin transactions to be conducted in an OBU, the ATO, in Taxation Determination TD 2014/25, has taken the view that bitcoin is not a foreign currency for the purposes of Division 775 of the 1997 Act, but presumably also for the purposes of Division 9A. Hence, trading in bitcoin with an offshore person would not appear to be within scope of Section 121D(4)(e) or (ea), which refer to "trading in currency." Similarly, to the extent that bitcoin is therefore properly construed as a commodity, it would not fall within the list of commodities that are eligible to be traded under Section 121D. Therefore, the only potential way in which bitcoin trading could be included in the OBU is where it acts as a hedge (that is, "is incidental to") an OB eligible contract activity, based on the 2015 amendment. For example, were an OBU to issue a derivative to an offshore person which references bitcoin, and seeks to hedge the exposure through acquiring bitcoin, then this would be permissible.

For similar reasons, borrowing or lending bitcoin would also not appear to be within scope to be conducted by an OBU, given that Section 121D(2) only refers to "money" that is "not Australian currency" or gold.

Consequently, the vast majority of transactions that are either denominated in a digital currency or where the counterparty looks to settle in a digital currency will not be eligible for OBU treatment.

It is noted that the Government is currently grappling with how to treat bitcoin and other digital currencies from a tax policy, regulatory policy and AML/CTF perspective, as evidenced by the recommendations of the Senate Economics Reference Committee Report "Digital currency – game changer or bit player,[41]" from August 2015. The Committee recommended, *inter alia*, that:

- digital currency be treated as money for GST purposes;
- there be further examination of appropriate income tax treatment of digital currencies as part of the current tax white paper process; and
- the Government establish a digital economy taskforce to gather information on the uses, opportunities and risks associated with digital currencies.

The Committee's report highlights that the regulatory and tax framework of bitcoin and other digital currencies will continue to evolve, and it is pivotal that the OBU regime keep pace with these developments and that the ability of digital currency transactions to be undertaken by an OBU be included in the policy assessment. To the extent that digital currency is a "financial arrangement" for the purposes of Division 230, then by allowing transactions in such currencies to be undertaken by an OBU then no incremental amendment to the OBU provisions would be required.

6.2.3 Blockchain innovation

While innovation in the payments space arising from digital currencies potentially will give rise to change in the ways in which financial market transactions are undertaken, the technology sitting behind digital

[41] Senate Economics Committee, *"Digital currency – game changer or bit player",* August 2015

currencies, known as blockchain or the distributed ledger, is considered to be potentially more transformative in altering the structures and processes for capital and financial market transactions. As stated by the CEO of Clearmatics, one of the larger companies seeking to bring blockchain technology to the capital markets:

> "the financial industry isn't interested in alternative money and digital currencies. It's interested in the distributed ledger. Distributed ledgers could replace the entire technological back end of dematerialized securities in real time, without the need for reconciliations and lots of financial controls. That's what financial institutions find interesting.[42]"

Broadly, blockchain technology, or the distributed ledger, is a digital record of ownership. Unlike existing ledgers, that are controlled and maintained by a central body, in blockchain the ledger is replicated across many different users in a peer-to-peer network (hence the use of the term "distributed") with an algorithm ensuring that each distributed ledger is identical and therefore capable of evidencing title to an underlying asset. This ability to prove ownership in a decentralised and efficient manner, which is clearly pivotal for digital currencies, can theoretically be extended to any other asset.

The perceived benefits of blockchain technology in a capital markets context include:

- speed and efficiency arising through the automation of the settlement process, particularly cross-border;
- disintermediation, that is, the removal of the requirement to interpose a trusted "third party" to administer the ledger, otherwise referred to in blockchain literature as the "decentralisation of trust[43]";
- reduced transaction costs through the elimination of registration systems and other intermediaries; and
- enhanced market access, given that the blockchain technology is without boundaries and hence global markets are more accessible to investors and issuers.[44]

In a tangible example of distributed ledger technology being applied in a financial markets context, on 22 January 2016 the ASX announced that it had selected a partner to "develop solutions for the Australian market using Distributed Ledger Technology," and that:

> "(a)doption of Distributed Ledger Technology has the potential to stimulate greater innovation by ASX and third parties to develop new services for intermediaries, end-investors and listed companies. This would create a more competitive marketplace across a broad range of services.[45]"

The segue between the emergence of distributed ledgers and their application in a financial markets context and the OBU regime is the expectation that such technology will initially assist with middle and back office processing, such as custody and settlement services that are currently unable to be meaningfully conducted by an OBU. In particular, the ability for distributed ledgers to both efficiently manage the clearing and settlement of transactions without the use of intermediaries has been

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[42] Robert Sams, as quoted in Sarah Todd, *"Banks can cherry-pick the best bits from Bitcoin*," American Banker, April, 2015.

[43] Alexander Westphal, "*Blockchain,* ICMA Regulatory Policy, Issue 39, 2015, p50.

[44] Greg Medcraft, *"The future of capital markets in a digital economy,*" 16 September 2015, p5.

[45] ASX Media Release, *"ASX Selects Digital Asset to Develop Distributed Ledger Technology for the Australian Equity Market,"* 22 January 2016.

highlighted, as has the use of distributed ledgers to efficiently evidence the existence of ownership of securities and other financial assets, as well as assisting with valuation, collateral management and corporate actions.

These are transactions that competitor regimes in the region allow to occur. Singapore, for example, allows the following transactions to be conducted and be eligible for the Financial Sector Incentive (**FSI**):

- corporate action processing services;
- pre-settlement confirmation and matching services;
- securities borrowing and lending processing services; and
- settlement and reconciliation services.

Further, the FSI regime generally allows for custodian services to be provided from Singapore as long as the payments for the services are not borne, directly or indirectly, by a Singaporean resident. This means that, in the author's view, such regimes will be able to bridge the gaps between Fintech innovation and the financial services sector more easily than Australia, given that the anticipated initial uses of distributed ledger technology are not eligible to be conducted by an OBU.

The concern, therefore, is that the location of investment in blockchain technology and the development of the use of distributed ledgers in a capital markets context, which by definition is entirely mobile given the ledgers themselves will have no real jurisdictional nexus, will be in jurisdictions that have regimes that provide appropriate taxation incentives. Through not adequately allowing for the provision of custody and settlement services in an OBU, not only does Australia run the risk of losing competitive advantage in developing the technology to other jurisdictions with respect to these transactions, it also runs the risk of where the technology is expanded to be applicable to currently eligible OB activities, such as securities trading and issuance of eligible contracts to offshore persons, the technology is housed by residents in other jurisdictions.

6.2.4 Future proofing

The above examples provide a cursory snapshot of some of the potential financial innovation and changes to transaction structures that may occur in the next decade. Given global spend on Fintech has been estimated to be currently exceeding $3 billion per annum[46], and increasing exponentially, it is likely that the innovations that are prevalent in a decade's time have not even been contemplated.

In order for the OBU regime to maintain competitiveness in an era of innovative flux, there will either need to be significant political will in prioritising amendments or additions to the regime (to the extent the current structure is maintained) or the overall structure of the regime needs to be modified so as to be able to adapt.

In terms of the three examples above, these could be addressed by a combination of the removal/refinement of the Section 121EA requirement coupled with tying eligibility for OB activities to other definitions that rely on principles or for which there is existing discipline to ensure contemporaneity.

[46] KPMG, *"Unlocking the Potential: The Fintech opportunity for Sydney,"* October 2014, p21.

7 Concluding remarks

In the current environment where corporate tax (and the potential avoidance thereof), and regimes which provide for concessionary treatment for certain transactions, are under unprecedented public scrutiny, it is perhaps understandable that the reforms to the OBU regime as legislated in 2015 fell short of the “bold and ambitious” reforms that industry had both hoped for and had been encouraged to articulate. However, the conflation of tax competition and tax avoidance has muddied the political waters somewhat, and concerningly has the potential to hold back worthwhile reforms that ensure that Australia’s taxation system is designed to deal with modern commerce.

As articulated in the Explanatory Memorandum to the 2015 amendments, the OBU regime is “designed to provide tax incentives to attract and maintain highly mobile financial sector activities within Australia.” The extent to which transactions in the financial services landscape pass the “highly mobile” test has the potential to increase hugely over the next decade, as financial innovation disrupts existing business models and presents paradigms where things are no longer done by people, and no longer done in a specific location. The OBU regime, together with other taxation settings, should support the attraction of such financial innovation to Australia and ensure that where the innovation occurs to facilitate financial transactions being undertaken with, and financial services being consumed by, offshore persons, the OBU regime is able to capitalise on the innovation opportunity and support the innovation continuing to benefit the Australian economy.

Governments should not be in the business of either backing winners or crystal-ball gazing as to what changes will be driven by future innovation; rather Governments should be considering whether the policy settings for attraction and retention of the benefits of innovation are appropriate and, to the best possible extent, future proof. The Government had an opportunity to make appropriate adjustments in relation to the OBU regime as part of the 2015 amendments; whether this was an opportunity lost or merely the first productive step in an on-going iterative process of reform remains to be seen.