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The Second Johnson Report – A Stocktake on Banking Recommendations

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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

In late 2016, the Financial Services Council issued a publication titled "Australia as a Financial Centre – Seven years on: The Second Johnson Report" (**the Second Johnson Report**). The catalyst for this report was to "measure how much progress has been made on [the Johnson Report] recommendations, with a focus on funds management (and)…highlights the barriers which remain and catalogues new barriers which have emerged or become apparent since the report was issued.[2]"

In relation to the recommendations that the Second Johnson Report reviewed, some progress was noted: the Investment Manager Regime has been fully legislated in all its tranches, there is progress on broadening the range of collective investment vehicles available in Australia and also on the Asia Regional Funds Passport, in relation to which Australia is a founding signatory. While additional barriers have arisen in the intervening seven years, from a holistic perspective the assessment of the progress of the Johnson Recommendations in relation to funds management is relatively positive. In the words of Mark Johnson, in the introduction to the Second Johnson Report:

> "The Report outlined an interrelated package of proposals designed to achieve [exporting of funds management]: the Asia Regional Funds Passport, a new range of collective investment vehicles and an Investment Manager Regime. Pleasingly, these recommendations have been progressed through the efforts of the Federal Government, Treasury, the Australian Securities and Investments Commission and the Australian Taxation Office.[3]"

There were a significant number of taxation-specific Johnson Recommendations that were driven by motivations beyond funds management and the export of Australia's financial services capability, such as lowering the cost of capital for Australian businesses, enhancing domestic banking competition and making Australia as an attractive location for undertaking global transactions. Unfortunately, for these recommendations, the progress report is less glowing.

The basis of this paper is to focus on those Johnson Report recommendations outside the funds management sphere and to highlight, as per the Second Johnson Report, those barriers that have arisen in the intervening period that impact on the global attractiveness of Australian financial markets and participants. The paper broadly concludes that implementation of these recommendations remains outstanding, and in relation to which Government commitment is, at best, unclear. In addition, the paper notes the abandonment of structural initiatives put in place as a result of the Johnson Report, specifically

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

[2] Financial Services Council, Australia as a Financial Centre – Seven years on: The Second Johnson Report", p3

[3] Financial Services Council, Australia as a Financial Centre – Seven years on: The Second Johnson Report", p2

the Financial Centre Taskforce, hindering the ability of Australia's financial services industry and its participants to engage with the Government to ensure policy settings most conducive to the promotion of Australia as a financial centre.

2 The Johnson Report

2.1 Background to the Johnson Report

In 2008, the then Minister for Financial Services, the Hon. Chris Bowen, commissioned the Australian Financial Centre Forum (**AFCF**), with the objective being to ensure "that Australia's policy settings allowed the financial sector to take full advantage of business opportunities in the region.[4]" In establishing the AFCF, the Government noted that the "initiative is seeking to capitalise on Australia's competitive advantages in the financial sector and exploit opportunities in the region to increase cross-border trade and investment in financial services. The end goal is to enhance the sector's contribution to domestic economic growth.[5]"

Twelve months later, in November 2009, the AFCF delivered its report officially titled "Australia as a Financial Centre: Building on our Strengths" but now universally referred to as **the Johnson Report**. The Johnson Report is a substantial review of the Australian financial sector and handed down a suite of recommendations that had as their aim to "substantially boost our trade in financial services and further improve the competitiveness and efficiency of our financial sector.[6]"

The potential benefits arising from the Johnson recommendations to Australian households, business and workforce would be twofold: lower costs and fees arising from the removal of barriers to offshore markets and enhanced job opportunities from the bolstering of Australia's financial services export capability. These recommendations touched on the themes of taxation, regulation and regulatory supervision and promotion of Australia as a financial centre.

2.2 The Johnson Framework

Before considering the specific Johnson Report recommendations in detail, it is appropriate to reflect on the framework that the AFCF envisaged being applied to the implementation of the recommendations.

At the time of the formation of the AFCF, there was an articulated vision statement to promote an Australian financial sector which "exhibits the lowest possible barriers to entry consistent with the maintenance of financial stability and integrity, so as to encourage new entrants and foster price competition and innovation.[7]" The recommendations are to remove barriers and impediments to competitiveness, efficiency and liquidity and allow the financial sector to rely on its skills, experience and reputation to encourage participants to conduct business in Australia.

Secondly, the AFCF noted that "the recommendations need to be seen as a package, designed to remove obstacles to Australian based companies engaging in more cross-border business and also to

[4] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p5
[5] "About the AFCF" - http://afcf.treasury.gov.au/content/default.asp
[6] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p1
[7] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p88

offshore companies and investors conducting more business in and through Australia.[8]" It should not be the case that the recommendations are viewed individually and only a select few are progressed (as was the case with the Henry Tax Review), given the holistic nature of the recommendations made in the Johnson Report. The requirement of the AFCF for the recommendations to be viewed as a package makes it incumbent on Governments to inform stakeholders as to their commitment to the recommendations, particularly given the long-term nature of some recommendations.

Lastly, given the effluxion of time between the issuance of the Johnson Report and now, it is no longer sufficient for Government's merely to implement the specific Johnson recommendations so as to enhance Australia's role as a financial centre. The world has moved on with new barriers emerging, as the Second Johnson Report and this paper highlight, and any Government that is truly committed to Australia as a financial centre will need to ensure that initiatives to promote Australia's role are fit for purpose based on current settings and barriers, not those that were prevalent in 2009. In this regard, the dismantling of the structures put in place by the Johnson Report to ensure connectivity between industry and government is particularly alarming.

2.3 Political Response

In order to appropriately provide a stock-take on the progress of the recommendations of the Johnson Report, it is worthwhile to consider the political context within which the Johnson Report was received and the apparent impetus for implementation of the recommendations from both sides of Government.

There is, at least publicly, bipartisan support for the Johnson Report and the recommendations contained therein. In early 2010, Minister Bowen issued a Media Release that welcomed the report, before providing a formal response to each of the recommendations in the 2010/11 Federal Budget, handed down in May 2010, where each recommendation was supported, either in principle or directly. The only caveat was that the recommendation to abolish the LIBOR Cap was to be the subject of further review; however as is set out in detail below, this review has been conducted and was supportive of the Johnson Recommendation. Hence, the former Labor Government that commissioned the Johnson Report was unanimous in its support of not only the report but each of the recommendations contained therein.

The 2013 Federal Election saw a change of Government, but not one that saw a change to support for the Johnson Report and its recommendations. That is, notwithstanding that the Johnson Report was commissioned by Labor, the Coalition has also stated its support for the Report and its recommendations. This was shown by the Coalition's pre-2013 election material, which stated that the Coalition would "give priority to the recommendations of the Johnson Report into Australia as a financial centre.[9]"

Given the apparent bipartisan support for the Johnson Report and its recommendations, it would be reasonable to expect that implementation of the recommendations may have been given some priority in the intervening period, particularly in respect of the recommended framework to promote Australia as a financial centre and to ensure Australia's policy settings remain current. Such bipartisanship is the

[8] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p109
[9] "Our Plan: Real Solutions for All Australians," p30

appropriate prism through which to assess the performance of both sides of government in the implementation of the Johnson recommendations.

3 Current Circumstances

3.1 Contribution of the Financial Services Sector

Given the broad objectives of the initiatives recommended in the Johnson Report, namely to boost the domestic financial sector and to lower the cost and enhance the accessibility of financial products and capital, it is useful to consider the contribution of the financial services sector to Australian GDP in the period since the Johnson Report. The Johnson Report noted that "Australia's financial sector is an important contributor to national output, employment, economic growth and development. The sector accounts directly for around 7.5 per cent of GDP, and employs directly around 390,000 people, or 3.6 per cent of total employment.[10]" In the intervening seven years, the relative contribution of the sector has increased: in 2016 Treasury noted that the contribution of the sector to Australia's GDP is $140 billion annually, or 9% of GDP, with direct employment up to 450,000[11].

In looking at the sector's direct contribution to the Australian economy, it is worthwhile reflecting on the comments in the Johnson Report that:

> "the financial sector's contribution to economic growth and output is much more important than these measures suggest. The financial sector is at the core of the economic system, providing a range of services which are necessary for other domestic and trade related industries to function efficiently and enabling consumers to effectively manage their consumption-savings requirements over time. While economic growth tends to induce accompanying financial sector growth, empirical research demonstrates a well-established causal link from financial sector development to economic growth.[12]"

This statement is consistent with AFMA's own empirical research. In a 2016 submission to the Productivity Commission's Five Year Productivity Review, AFMA noted that "(t)he financial sector…contributes directly to productivity growth through its own share of output and indirectly through its contribution to the efficiency of the capital stock and social value of the information produced by financial markets." Further, measures that are "benefiting the financial sector are likely to yield broader economic gains given the centrality of financial services to the efficient allocation of capital that in turn determines the productivity of investment.[13]"

The contraction in the Australian economy in the third quarter of 2016 is a timely reminder for the Government to consider initiatives that support not only Australia's largest contributor to GDP but also are likely to yield broader economic gains and boost productivity growth, particularly through enhancing access to offshore capital and reducing the cost of capital for Australian business.

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

[11] The Treasury "Backing Australian FinTech" July 2016.

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

[13] AFMA "Increasing Australia's Future Prosperity: Submission to Five Year Productivity Review," 2016, p28

3.2 Relative Performance of Australia's Financial Centres

Australia is unlike many other jurisdictions that promote themselves as a centre for financial activity, insofar as it has two distinct centres in which to conduct such activity: Sydney and Melbourne. This can be contrasted with Singapore, Hong Kong and even London, where there is a concentration of the financial activity within one centre. Indeed, as noted in a recent CIFR Research Paper, there is a positive correlation between the concentration of financial activity in one centre to the ability to attract financial activity.[14] That being said, for the purpose of evaluating Australia's relative performance, it is appropriate to focus on the relative performance of Sydney.

The most objective measure of the performance of financial centres is the Global Financial Centres Index (**GFCI**), which has a ranking of the competitiveness of financial centres based on a combination of questionnaire responses and other indices for instrumental factors such as business environment, financial sector development, infrastructure, human capital and reputation, with the indices being sourced from organisations such as the World Bank and the OECD. The GFCI is published twice annually, having been first published in 2007 and the ranking and rating for Sydney in each of the GFCI publications is set out below:

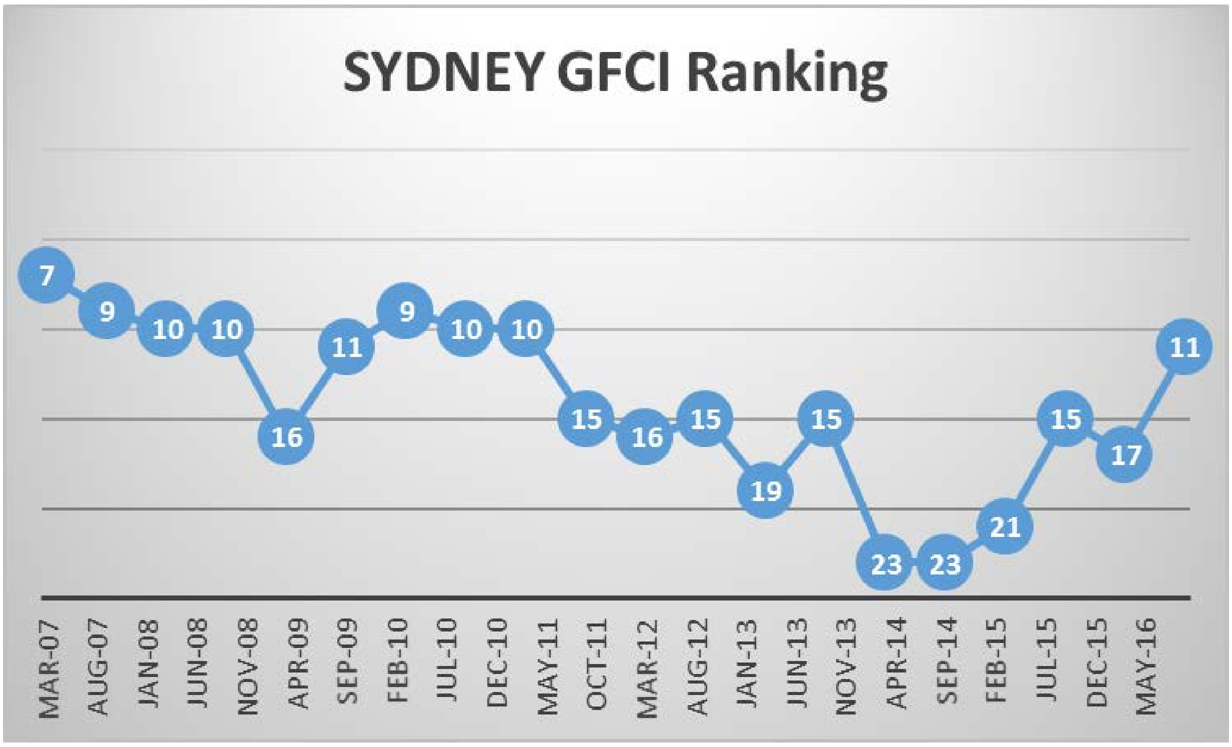
Table 1 – Sydney GFCI Ranking & Rating

GFCI Number	Month/Year	Sydney Ranking	Rating
1	March 2007	7	639
2	September 2007	9	636
3	March 2008	10	630
4	September 2008	10	621
5	March 2009	16	610
6	September 2009	11	651
7	March 2010	=9	670
8	September 2010	10	660
9	March 2011	=10	658
10	September 2011	15	669
11	March 2012	16	674
12	September 2012	15	670
13	March 2013	19	686

[14] Wojcik, Knight & Pazitka, "What turns cities into international financial centres?" Centre for International Finance and Regulation, November 2015

14	September 2013	15	692
15	March 2014	23	690
16	September 2014	23	682
17	March 2015	21	690
18	September 2015	15	705
19	March 2016	17	692
20	September 2016	11	712

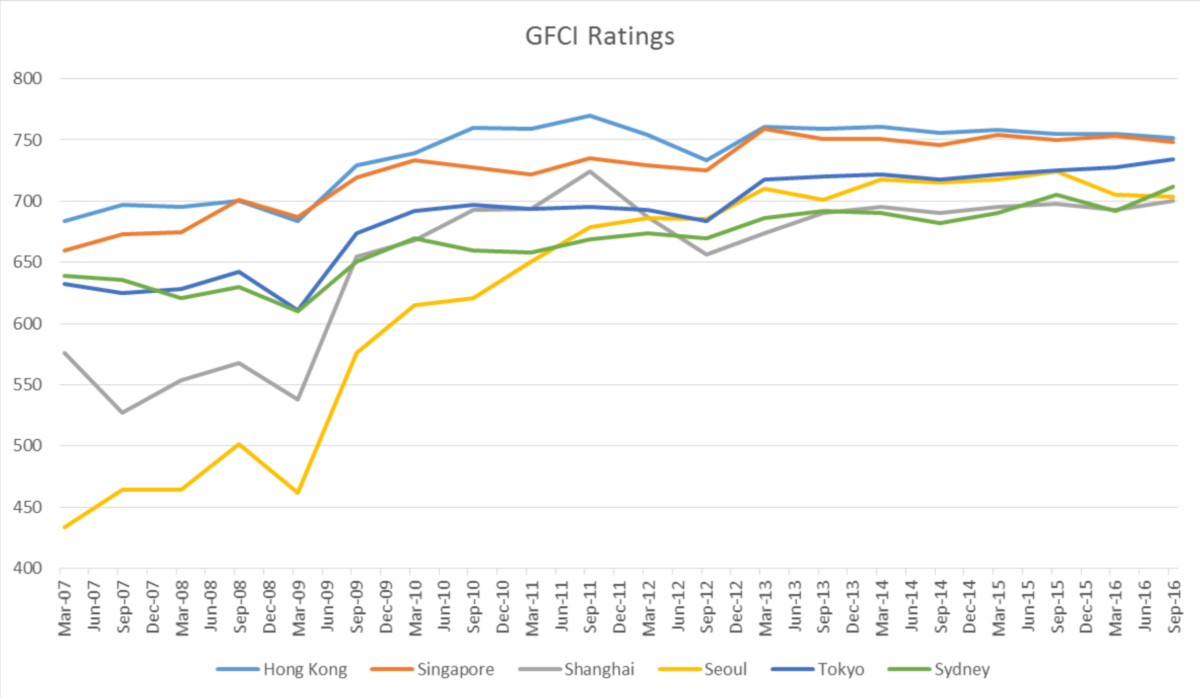
Chart 1 – Sydney GFCI Ranking



These rankings demonstrate that while Sydney occupies a similar global ranking to that at the time of the Johnson Report, there was a significant lowering of the ranking in the intervening period. This was notwithstanding that the actual rating exhibiting a generally upward trend over the nine year period. This shows that while Sydney's relative competitiveness as a financial centre fell merely through a lack of action, as other centres, particularly Shanghai and Seoul, more proactively pursued policies that promoted financial centre activity.

This may be demonstrated through plotting the rating of Sydney as a financial centre against other regional centres.

Chart 2 – Sydney GFCI Ranking in Asia



This ranking of 11 for Sydney is consistent with the assessment undertaken by Wojcik, Knight and Pazitka, that ranked Sydney as 10th globally, based solely on cross-border investment banking fees as opposed to any subjective criteria[15]. Of interest in determining this ranking is the disparity in cross-border fees earned by the largest global financial centres and Sydney: during the relevant period Sydney accrued USD $5.126 billion of fees, compared to London at USD $130.943 billion and New York at USD $125.242 billion.

The recent uptick in Australia's ranking and rating in the GCFI index is interesting. Noting the comments from Mark Johnson in the introduction to the Second Johnson Report above, the progress that has been made in relation to enhancing Australia's financial services export capability through the enactment of the Investment Manager regime and the signing of the Asia Regional Funds Passport, together with the commitment to Collective Investment Vehicle reform, has resonated with those responding the GFCI questionnaire. This would suggest that additional reform, or even commitment to such reform would improve Australia's ranking and rating further. Secondly, recent world events such as Brexit may have given rise to uncertainty for participants as to the stability and robustness of existing financial centres and rendered those centres that are relatively unaffected by such events, such as Australia, as comparatively preferable. Both of these factors promote the timeliness of further Government reform to highlight Australia's financial centre capabilities.

[15] Wojcik, Knight & Pazitka, "What turns cities into international financial centres?" Centre for International Finance and Regulation, November 2015, p9

4 Specific Johnson Recommendations

The Johnson Report contains 19 discrete recommendations, grouped under three main headings:

- Taxation (Chapter 3 of the Report);
- Regulation and regulatory supervision (Chapter 4 of the Report); and
- Promoting Australia as a financial centre (Chapter 6 of the Report).

4.1 Withholding Tax on Interest for Financial Institutions

Recommendation 3.4: Withholding tax on interest paid on foreign raised funding by Australian banks; on interest paid to foreign banks by Australian branches; and on financial institutions

- ***Remove withholding tax on interest paid on foreign raised funding by Australian banks, including offshore deposits and deposits in Australia by non-residents.***
- ***Remove withholding tax on interest paid to foreign banks by their Australian branches.***
- ***Remove withholding tax on financial institutions' related party borrowing.***

4.1.1 Basis for the Recommendation

A key recommendation of the Johnson Report in terms of improving access to debt capital was the proposal to remove interest withholding tax on interest paid by financial institutions operating in Australia.

The basis for this recommendation is straightforward. The Johnson Report notes that there are a number of structural reasons as to why Australia has historically been, is currently and is likely to continue to be a net importer of capital. Accordingly, in order to effectively fund the economy, it is necessary that "Australia needs access to a diverse range of offshore savings pools to finance domestic investment needs.[16]" As a result, there was a general reluctance from the AFCF to endorse tax policy measures that increase the cost of capital and any changes that improve access to offshore capital at lower cost are "clearly in Australia's interest.[17]"

Johnson raised a further, more specific issue in relation to the Global Financial Crisis, whereby funding pressures arising from difficulties in wholesale credit markets impacted on the capacity for Australian businesses to access debt capital from traditional sources, and "reinforced the need for more diversified funding sources.[18]"

[16] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p64

[17] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p64.

[18] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p64.

The imposition of a 10% interest withholding tax on payments of interest[19] from Australia to a lender offshore was highlighted as a key measure stymying access to offshore debt markets, particularly noting the observation that Australia's interest withholding tax regime is inconsistent with other financial centres. The effects of applying interest withholding tax on commercial and retail borrowing by banks were:

- To raise the cost of capital for Australian banks borrowing offshore, and hence for Australian businesses and households that borrow from banks, particularly given the market practice to require the borrower to "gross-up" for the amount of the withholding tax; and
- To give rise to significant competitive distortions and inconsistencies by virtue of the application of interest withholding tax to some, but not all, offshore borrowings by Australian-based financial institutions. This is a function of both the exemptions enshrined in the domestic law, such as Sections 128F and Section 128GB of the ITAA 1936 and also the increasing prevalent interest withholding tax exemptions for unrelated financial institutions in recently negotiated Double Taxation Agreements.

These effects led the AFCF to conclude that:

> "the continued application of interest withholding tax on financial institutions' borrowing offshore sits uneasily with the Government's desire to develop Australia as a leading financial centre and is putting Australia at a competitive disadvantage with respect to overseas financial centres, which increasingly do not charge interest withholding tax on such transactions[20]"

and ultimately to make recommendation 3.4.

The incongruity of imposing interest withholding tax on financial institutions by a nation that is a net importer of capital was also acknowledged by the Henry Tax Review, which recommended that "financial institutions operating in Australia should generally not be subject to withholding tax on interest paid to non-residents.[21]"

4.1.2 Government Response to the Recommendation

In the May 2010 Government response to the Johnson Report in the 2010/11 Federal Budget, the Government announced that it would phase down the interest withholding tax applicable to payments of interest:

- By foreign bank branches to head office to 2.5% from 2013-14 and 0% from 2014-15; and
- By other financial institutions/borrowings to 7.5% from 2013-14 and 5% from 2014-15.

The Government statement that accompanied the announcement stated that "(t)he main IWT rate will come down from 10 per cent to 5 per cent and we will reduce that to zero when fiscal circumstances

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[19] Including amounts in the nature of interest, in substitution for interest or amounts received in relation to a washing arrangement – refer Section 128A(1AB) of the ITAA 1926

[20] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p68

[21] "Australia's Future Tax System – Report to Treasurer" December 2009, Part Two, p182.

allow.[22]" This measure was part of the tax reform package that the Government committed to at the 2010 G-20 summit in Seoul.

On 23 November 2011, the then Assistant Treasurer, the Hon. Bill Shorten, announced a one year deferral of the commencement of the of the phase-down of the interest withholding rates for financial institutions "because fiscal circumstances have changed due to global economic events.[23]" The Government went on to say that "we remain committed to this measure from 2014-15, unlike the Opposition that do not support this measure.[24]"

Due to the Federal election in September 2013 and the subsequent change of Government, the announced implementation of the measure did not materialise.

Notwithstanding the strength of this comment from the then Government as to the extent to which the phase-down of interest withholding tax for financial institutions does not have bipartisan support, the stance from the current Government is more difficult to ascertain. It is true that the proposed phase-down has not been implemented; however what is unclear is whether this is a function of the current Government not supporting the measure from a policy perspective or whether the failure to implement the recommendation is more practical in nature, that is, due to a perception from the current Government that the former Government was planning to fund any revenue shortfall arising from the interest withholding tax phase-down from the proceeds of the Minerals Resources Rent Tax (**MRRT**).

Prior to the 2013 Federal Election, the then Shadow Treasurer and Shadow Minister for Finance, Deregulation and Debt Reduction issued a media release entitled "Coalition's Responsible Budget Savings." In this media release, the savings that would be made as a consequence of the proposed abolition of the MRRT were announced; these included "discontinuing the phasing down of interest withholding tax on financial institutions." The revenue impact for the discontinuance of the phase-down of the rate of interest withholding tax for financial institutions was estimated to be $400 million over the forward estimates period. The media release did not articulate the basis for the discontinuance of the phase down from a policy perspective, except for the assumption that the phasing down was part of a spending package funded by the MRRT. As such, stakeholders were unsure as to whether the catalyst for the discontinuance of the phase-down was conceptual or merely due to hypothecation against a perceived diminuition of Government revenue.

Further blurring the Government's stance on whether there is at least in-principle support for implementing the recommendation, there have been a number of comments from those that now preside over relevant Government portfolios at various junctures that suggest that there is conceptual support for the phase-down of interest withholding tax for financial institutions. For example, the then Shadow Assistant Treasurer and now Minister for Finance, The Hon. Mathias Cormann, stated at the 2012 Financial Services Council conference:

> "The Johnson Report outlined a number of policy setting changes that would help Australia become a regional financial centre. The key recommendations focused on regulatory and tax changes to make investment easier and more attractive. The recommendations

[22] "Government Responds to Australia as a Financial Centre Report" – Minster Bowen and Minister Sherry, 11 May 2010

[23] "One Year Deferral of Interest Withholding Tax Phase Down," Minster Shorten, 23 November 2011.

[24] Ibid.

> included…reforms to the interest withholding tax regime…The Coalition continues to support the principles of the Johnson Report recommendations."

As such, the current state of play in relation to whether there is Government support for the phase-down for interest withholding tax for financial institutions is unclear. The current Government supports the Johnson Report recommendations, apparently in full, and a Senior Cabinet Minister is on the record articulating the specific interest withholding tax recommendation and simultaneously conforming support for the recommendations. On the flip-side, the phase-down was abandoned at the time of the repeal of the MRRT and Labor are of the view that the Government does not support this particular recommendation, as set out in the November 2011 Press Release.

4.1.3 Subsequent Events and Consideration

Reviews, including those commissioned by the current Government, continue to lend their support to the abolition, or at least a phase-down, of interest withholding tax for financial institutions. Most notable was the 2014 Final Report of the Financial System Inquiry (**FSI**), chaired by David Murray.

The FSI was, in the writer's view, significantly hamstrung through taxation being effectively excluded from its terms of reference, which stated:

> "(t)he inquiry will examine the taxation of financial arrangements, products or institutions to the extent these impinge on the efficient and effective allocation of capital by the financial system and provide observations that could inform the Tax White Paper[25]."

The salient point is that the inquiry could only provide observations, and not recommendations, in relation to distortions arising in the financial system due to taxation settings. Given the Government's subsequent junking of Tax White Paper process, the inability of the FSI to provide recommendations into taxation matters impinged upon the extent to which it may be considered to be a holistic review of the financial system. This is particularly the case given the Government did not need to, nor took the opportunity to, respond to the observations in its response to the FSI, as handed down in October 2015.

Notwithstanding, the FSI Panel did take the opportunity to observe strongly in relation to the appropriateness of interest withholding tax in an Australian context. The FSI noted that:

> "(r)educing the uncertainty and scope of taxes on cross-border flows would improve Australian entities' access to offshore savings. Access to offshore funding markets provides Australian entities with cheaper funds than otherwise would be the case. Having access to more diverse sources of funding reduces the risk from dislocation in one or more funding markets…(w)ithholding tax increases the required rate of return for non-residents, which reduces the attractiveness of Australia as an investment destination. In cases where the non-resident can pass on the cost, the cost of funding is raised in Australia.[26]

This perspective was the catalyst for the FSI Panel to observe:

[25] Financial System Inquiry – Terms of Reference, No. 6. http://fsi.gov.au/terms-of-reference/
[26] "Financial System Inquiry – Final Report," November 2014, pp17-18

> "(f)or financial institutions, different funding mechanisms are subject to different rates of IWT. Reducing IWT (for the relevant funding mechanisms) would reduce funding distortions, provide a more diversified funding base and, more broadly, reduce impediments to cross-border capital flows.[27]"

It is noted that these comments were cited with approval in the Re:Think Tax Discussion Paper[28].

4.1.4 Summary Comments

The continued uncertainty around the conceptual support for the Johnson recommendation in relation to the phase-down, and ultimate abolition, of interest withholding tax for financial institutions is a significant impediment on enhancing Australia's status as a financial centre. The conceptual argument should be unimpeachable; Australia is a net importer of debt capital and hence any frictions that stymie the attractiveness as Australia as a destination for such capital are contrary to the national interest. The fact that the Henry Tax Review and the Financial System Inquiry endorsed the Johnson comments provide little latitude for dissenting views. The fact that the current Government has not endorsed this view, and indeed caused stakeholders to question the extent to which the Government supports the recommendation in principle, is a cause for considerable concern.

To the extent that there is bipartisan support for the phase down/abolition of interest withholding tax for financial institutions, but implementation of the recommendation is to occur at a time when appropriate in terms of the state of the Federal Budget, then this would be a worthwhile statement for the Government to make. In the absence of such a statement, the Government can no longer claim to be supportive of the Johnson recommendations.

4.2 Abolition of the LIBOR Cap

> ***Recommendation 3.5: Remove the LIBOR Cap on deductibility of interest paid on branch-parent funding***

4.2.1 Basis for the Recommendation

The LIBOR Cap is a measure contained within Part IIIB of the ITAA 1936 (the primary code for the taxation of foreign bank branches) that operates to deny deductibility of intra-entity interest for an Australian branch of a foreign bank above the applicable LIBOR. Specifically, Section 160ZZZA(1)(c) provides that

> "if the interest on the notional borrowing at the relevant time was at a rate of interest that exceeded the LIBOR that was applicable at the beginning of the relevant interest calculation period in relation to the notional borrowing, there is taken to have been entered in the branch's accounting records at the relevant time…the amount that would have been so entered if the

[27] Financial System Inquiry – Final Report," November 2014, pp279

[28] "Re-Think Tax Discussion Paper" March 2015 p95.

> interest on the notional borrowing for the relevant interest calculation period had been calculated at the LIBOR that was applicable at the beginning of the period."

In determining the applicable LIBOR, consideration is to be made as to the currency of the notional borrowing and also the term of the notional borrowing.

AFMA has long maintained that the LIBOR Cap is inconsistent with appropriate competition, regulatory or tax policy and continues to strongly recommend the removal of the LIBOR Cap.

The taxation inequities imposed by the LIBOR Cap was one of a number of factors that contributed to a sharp decline in market share held by foreign banks when compared to the levels exhibited prior to the GFC. Thus, the LIBOR Cap has the effect of reducing bank competition by increasing the funding costs for foreign banks and thereby hinders the ability of foreign banks to compete in the business loan market. It can be especially penal for new market entrants who may have greater reliance on parent funding as they establish their business and funding capacity in Australia.

Further, as noted by the Johnson Report, to the extent that the LIBOR Cap unnecessarily inhibits the flow of capital into Australia, it increases the availability and cost of credit to Australian business. Abolition of the LIBOR Cap would be viewed as a welcome step towards allowing Australia to compete with regimes such as Singapore and Hong Kong as a financial centre. The abolition would encourage foreign banks to conduct more business in Australia and help provide the critical mass and diversity of business required to sustain financial services exports at the desired level.

Moreover, the LIBOR Cap is unique to Australia and the concept is hard to understand for both tax and non-tax managers in a foreign bank's head office and, rightly or wrongly, creates an impression of risk. It presents the Australian tax regime as being complex, hard for senior management overseas to understand and unwelcoming to banks that wish to transfer funds into the Australian economy through a branch operation.

The Johnson Report acknowledged the policy flaws associated with the LIBOR Cap. In particular, it was noted that "in periods of stress in credit markets there can be appreciable differences between the LIBOR rate and the rates that parent banks are able to offer their Australian branches on a commercial basis and that while, at the time of the Report, conditions in credit markets had eased, "Australia needs policies to ensure access to alternative funding sources should such tensions re-emerge.[29]" In addition, the AFCF rightly pointed out that any concerns regarding the inflation of deductions for the Australian branch of the foreign bank could be addressed through existing transfer pricing provisions, such as those contained in Division 815 of the ITAA 1997.

4.2.2 Government Response to the Recommendation

The Government response to the recommendation issued in May 2010 was as follows:

> "The Government will ask Treasury to review the LIBOR Cap…The Government will respond to this recommendation when this review has been completed.[30]"

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[29] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p69

[30] "Government Responds to Australia as a Financial Centre Report" – Minster Bowen and Minister Sherry, 11 May 2010

This review was undertaken by the Board of Taxation, as part of its Review of Tax Arrangements Applying to Permanent Establishments. This Review was announced in May 2012 with the Board obliged to report to Government by April 2013. Under the Terms of Reference for the review, the Board was asked to:

> "review the current special rule that limits the deemed interest deduction on internal funds used by foreign banks in their Australian branches to the LIBOR…The Board was asked to advise on the continued appropriateness of having a safe harbour for the interest rate that may be charged for the use of internal funds by foreign banks in their Australian branches, as a proxy for arm's length interest rates, and if so the suitability of the LIBOR cap for that role.[31]"

The Board's report considered a number of issues in determining the ongoing appropriateness of the LIBOR Cap, including effects on banking competition and taxation revenue. The report noted:

> ""(t)he Board agrees that the LIBOR cap has the potential to reduce bank competition. Put another way, it is hard to see how a cap on the amount of deductions that can be claimed in respect of intra-entity debt can assist in promoting banking competition by foreign banks with their domestic counterparts that do not face the restriction…The LIBOR cap has the effect of potentially increasing the funding costs for foreign bank branches and hinders their ability to compete in the business loan market. Moreover, new entrants into the Australian banking market are likely to be disproportionately affected by the LIBOR cap because they are relatively more reliant on head office funding to which the cap applies.[32]"

Ultimately, this led the Board to recommend that "subject to confirmation that the removal of the LIBOR cap would result in no material cost to tax revenue, the cap should be removed.[33]" It is noted for completeness that this recommendation, which importantly was the only recommendation of the entire report, was to be implemented in the context of Australia adopting the functionally separate enterprise approach for financial institutions.

AFMA noted that one of the conditions associated with the Board's recommendation was that there needed to be confirmation that the removal of the LIBOR Cap would result in no material cost to tax revenue, and accordingly during the 2014 calendar year AFMA surveyed its members to determine the revenue impacts of the abolition of the cap. This survey found that the impact to revenue was indeed immaterial and in terms of actual tax would be less than $10 million per annum and would deliver a deregulation benefit across the foreign bank population of approximately $3.5 million per annum.

While the Board delivered its report to Government in April 2013, disappointingly it was not released publicly until June 2015. What was even more disappointing was that the Government abandoned its longstanding protocol of releasing its response to the Report at the time that it was released publicly and accordingly stakeholders, such as AFMA and its members, are still none the wiser as to the Government's view on the specific recommendation in relation to the LIBOR Cap, as well as the other important matters canvassed in the Board's report.

[31] Board of Taxation "Taxation Arrangements Applying to Permanent Establishments" Terms of Reference
[32] "Review of Tax Arrangements Applying to Permanent Establishments," Board of Taxation, April 2013, pp73-74
[33] Ibid, p74

4.2.3 Subsequent Events and Consideration

Subsequent to the delivery of the Board's report to Governement, there have been three subsequent occurrences that have further reinforced the extent to which the LIBOR cap is defective from a tax policy perspective and that the Johnson Report recommendation should be implemented.

Firstly, in 2013 the then administrators of LIBOR, the British Bankers' Association, ceased to quote LIBOR in Australian Dollars, as well as other currencies such as New Zealand Dollars and Canadian Dollars. This resulted in a situation where there was no applicable LIBOR in respect of AUD borrowings and consequently no cap on deductibility of interest where the notional borrowing by the Australian branch was in its own functional currency. This necessitated agreement between AFMA and the ATO of a safe harbour that may be applied by foreign bank branches in relation to AUD borrowings. However from a purely technical perspective, there is now the apparently untenable situation where there exists a provision of the domestic law which has no legal effect where the Australian foreign bank branch borrows in its own functional currency.

Secondly, certain currencies in which LIBOR continues to be quoted, such as EUR and JPY, now exhibit negative interest rates such that the "applicable LIBOR" for the purpose of applying Section 160ZZZA of the ITAA 1936 is negative. This again resulted in dialogue between AFMA and the ATO to confirm that a foreign bank branch would not derive assessable income on a payment made on a notional borrowing where the applicable LIBOR was a negative amount. The prevalence of negative interest rates highlights the impracticalities that may arise in applying the LIBOR cap and demonstrate the extent to which it is no longer fit for purpose.

Finally, as per the interest withholding tax discussion above, the Final Report of the FSI considered the LIBOR cap and its impact on the financial system. Noting again that the FSI Panel was curtailed in its ability to provide recommendations in relation to taxation matters, the Final Report observed:

> "(f)or foreign bank branches in Australia, interest paid on funds borrowed from the offshore parent is deductible, limited to the London Interbank Offered Rate (LIBOR) cap. This can prevent the branch from claiming the full interest cost of the borrowing.[34]"

This observation represents a specific acknowledgement from the FSI Panel that the "applicable LIBOR" for the purpose of applying the LIBOR Cap understates the appropriate (i.e. arm's length) borrowing cost for the foreign bank branch, thereby placing such foreign bank branches at a competitive disadvantage vis-à-vis their domestic counterparts.

4.2.4 Summary Comments

The failure of successive governments to abolish the LIBOR Cap is an indictment on a number of levels. Primarily, the LIBOR Cap is defective tax policy insofar as it applies only to a sub-set of Australian inbound banks operating through a branch, who are accordingly placed at a competitive disadvantage vis-à-vis local banks, bank subsidiaries or those foreign bank branches that have elected out of Part IIIB by virtue of being headquartered in a jurisdiction that has concluded a Double Taxation Treaty with

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[34] Financial System Inquiry – Final Report," November 2014, pp279

Australia. The strengthening of Australia's transfer pricing regime, through the enactment of Division 815 of the ITAA 1997, has rendered the LIBOR Cap as increasingly redundant.

Secondly, the recommendation to abolish the LIBOR Cap has been confirmed by the Board of Taxation, subject to two conditions. The first, that the abolition of the cap give rise to no material cost to revenue, has been confirmed by AFMA through a survey of its members. The second condition is that the abolition of the cap occur at the same time as the adoption of the functionally separate enterprise approach to determine the profit attributable to bank branches. Unfortunately, given the Government has failed to provide any response to the Board's report generally, and this recommendation in particular, then whether this condition may be met through future reform cannot be ascertained.

Lastly, subsequent events such as the abolition of AUD LIBOR and negative interest LIBOR's in other currencies have exacerbated the absurdity of the LIBOR Cap, necessitating engagement by industry with the ATO to achieve administrative outcomes where the law is technically deficient.

The continued existence of the LIBOR Cap in these circumstances again calls into question the Government's commitment to the implementation of the Johnson recommendations.

4.3 Modernisation of the Offshore Banking Unit Regime

Recommendation 3.2: 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 also 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 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 with 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.***
- ***A streamlined process for vetting new OBU applications be put in place:***
    - ***with a requirement that an application be approved or denied within six months of its receipt, subject to all the appropriate application material being lodged;***
    - ***with revised administrative changes for the 'other company' category. The Forum proposes that the guidelines 4(q), 4(r) and 4(s) in the*** **Income Tax Assessment (Determination of Offshore Banking Activities) Guidelines 1999** ***be satisfied by an external auditor (or equivalent) verification; and***
    - ***that these new arrangements be reviewed by Treasury 18 months after their adoption to ensure they are working effectively.***

4.3.1 Basis for the Recommendation

The Offshore Banking Unit (**OBU**) regime was an area of considerable focus of the AFCF, which is understandable given that the policy rationale for the OBU regime can cover both the facilitation of the export of financial services from Australia, by providing incentives for eligible businesses to operate from Australia and provide services to "offshore persons" and also the attraction of mobile capital to Australia through, amongst other things, a withholding tax exemption for interest paid on eligible borrowings. It is clear that the AFCF rightfully acknowledged the importance of the OBU regime as a key pillar in promoting Australia as a financial centre. Indeed, as noted in the Johnson Report:

> "(t)he Forum believes than an effective OBU regime is a key element in ensuring that Australia's financial sector takes full advantage of opportunities to participate in international transactions. The recommendation below is designed to ensure our OBU regime and its objectives are well understood and that the regime is effective. It is significant that, despite over 20 years of the regime being in place in Australia, OBU usage has been relatively limited[35]."

With respect to the specific recommendations, the basis for the recommendation for the Government statement of support for the regime was based on an observation by the AFCF that it was:

> "struck by the lack of awareness amongst many financial market participants of the objectives and potential benefits of the OBU regime.[36]""

It was felt by the Forum that a statement of support would both highlight the potential advantages of the regime and also engender confidence in those that may wish to undertake transactions through an OBU that the regime would continue to have longevity and continued competitiveness, thereby providing confidence that any expenditure incurred in establishing an OBU or complying with the various requirements would not be in vain.

In relation to the recommendation on the "choice principle," the AFCF 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…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.[37]"

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.[38]'

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[35] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p61
[36] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p61
[37] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p58
[38] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p58

Finally, in relation to the recommendation regarding the streamlining of new OBU applications, the catalyst for this recommendation was an observation from the AFCF that the process for assessing new OBU applications could be extremely slow and complex, particularly for applicants in the "other company" category.

In summarising the recommendations in relation to the OBU regime, the AFCF 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.[39]" Further, implementation of the recommendations would be "critical to achievement of the Government's objectives and ambitions for Australia's financial sector,[40]" and "have the potential to generate additional taxable income, jobs and benefits to domestic consumers from greater economies of scale and lower fees.[41]"

4.3.2 Government Response to the Recommendation

In respect of Recommendation 3.2, regarding OBUs, the Government fell short of 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."

Further, the Government response did not place a timeframe on the release of the Discussion Paper and the commencement of the consultation process, notwithstanding overtures from industry seeking to engage on potential reforms to the regime. This Discussion Paper was only finally released in June 2013, some three years after the commitment from the Government to consult. It is noteworthy in this regard 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.

4.3.3 Subsequent Events and Consideration

The issuance of the OBU Discussion Paper in 2013 led to significant stakeholder engagement in relation to the potential modernisation of the OBU regime, including the potential implementation of the recommendations of the Johnson Report[42]. This engagement resulted in the passage of the *Tax and*

[39] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p58
[40] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p58
[41] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p58
[42] The full OBU reform agenda is beyond the scope of this paper. However, such reform was covered in detail in my paper presented at the 2016 Financial Services Conference titled "Bold and Ambitious? The 2015 Amendments to the OBU Regime: An Industry Perspective."

Superannuation Laws Amendment (2015 Measures No. 1) Bill 2015 that included reforms to the OBU regime.

In terms of the four individual recommendations of the Johnson Report, only one has clearly been implemented, namely the recommendation in relation to resolving the tax uncertainty about "choice."

With regards to the list of eligible OB activities, while it is true that a number of amendments in the 2015 legislation were in relation to eligible OB activities, all but one of these merely clarified the ambit of existing activities or addressed a technical issue in relation to the parameters of the activity. The exception was the inclusion of leasing as an eligible OB activity, on the basis, as set out in the accompanying Explanatory Memorandum, that:

> "(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.[43]"

Moreover, the 2015 amendments did nothing in terms of streamlining the process for updating the activities eligible to be conducted by an OBU. The "laundry-list" of eligible activities is still contained within Division 9A of the ITAA 1936. Further, regarding the aspect of the recommendation that the Regulations would be made on advice from the proposed "Financial Centre Task Force," this task force was wound up prior to any consideration of potential expansion of eligible-OB activities. 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.

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, meaning that there is little opportunity for industry to engage to ensure that the review of eligible OBU activities is "timely and efficient." Further, the consistent requests from industry that the eligibility of activities to be conducted by an OBU be determined on a more principles basis have fallen on deaf ears. As such, in the intervening period between the issuance of the Johnson Report and the now, the only change to the process to determining the activities eligible to be conducted by an OBU is the inclusion of a new class of activities of leasing.

The recommendation in respect of the application process has also not been the subject of any reform, although the recommendation has also not been the subject of industry engagement or dialogue with Treasury.

Finally, the recommendation to provide a statement of support for the OBU regime is also, in the writer's view, outstanding. And, in the writer's view, this recommendation is the most important in terms of ensuring that the OBU regime delivers on its policy objectives.

Given the three year delay between committing to consultation on implementation of the Johnson OBU recommendations to the release of such the OBU Discussion Paper, with a change of Government in the interim, potential OBU participants have every right to question commitment to the regime from both sides of politics. 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. The lack of response also shapes the

[43] Explanatory Memorandum to the Tax and Superannuation Laws Amendment (2015 Measures No. 1) Bill 2015, paragraph 3.92

consultation processes, with an apparent reluctance from Treasury to prioritise the commitment of resources to wholesale reform in the absence of a clearly articulated political imperative to do so. The writer 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.

4.3.4 Summary Comments

The legislative amendments to the OBU in 2015 are symptomatic of a Government looking at the Johnson recommendations as a "tick the box" exercise, as opposed to ensuring that the regime remains contemporaneous and competitive in light of financial product and market innovation. Generally, the amendments were positive and the Government should be commended for addressing the "choice" issue in a manner that is relatively clear. However in terms of the Johnson recommendations of a publicly articulated statement of support for the regime and the creation of a framework that would facilitate dialogue between the Government and industry to ensure that the regime remains current, both remain outstanding. In addition, there have been a number of proposals from industry that would ensure that the regime that the OBU regime did not languish behind similar regimes adopted by other financial centres in the region, and these have not been adopted.

4.4 Other Johnson Report Recommendations

The three Johnson Report recommendations considered above are the key recommendations seeking to improve the ability of access of Australian-based enterprises to offshore capital. There are other recommendations which, if implemented, would ensure that the policy settings that seek to promote Australia as a financial centre remain contemporaneous and competitive. These include:

- **Recommendation 3.8** As part of its six-monthly reports to Government, the Financial Centre Taskforce is to:
    - monitor progress on the implementation of the tax recommendations of the Report that are accepted by Government and report on any specific concerns on the financial sector from their implementation;
    - monitor changes in taxation legislation or administration in overseas financial centres with a view to identifying any measure which it considers worthy of closer examination for possible adoption in Australia; and
    - make recommendations where it sees a case for review of existing tax legislation that may conflict with the objective of promoting Australia as a financial centre[44];
- **Recommendation 6.1:** The Forum recommends that the Australian Government make a declaration of its intent to maintain and improve the openness, competitiveness and regional engagement of Australia's financial sector, including within the broader context of greater regional integration and cooperation.

[44] Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p75

- **Recommendation 6.3:** The Forum recommends the establishment of a Financial Centre Taskforce.

The Government response to these three recommendations was identical and is set out below:

> "The Government has asked Mark Johnson to chair a Financial Centre Task Force (the Taskforce) of senior financial sector representatives to continue its work in promoting Australia as a financial centre for the region and facilitate industry input into the design of a range of proposals including the Asia Region Funds Passport, the Investment Manager Regime, and funds management vehicles.
>
> The role of the Taskforce will cover three areas:
>
> - Regional engagement and enhancing Australia's presence in Asia;
> - Engagement with domestic industry on an informal basis; and
> - Facilitation of industry input into the design of several of the key outputs that flow from the recommendations of the Johnson Report.
>
> The Taskforce will be supported by a dedicated Secretariat."

As such, the appointment of the Financial Centre Taskforce may be objectively viewed as a key pillar in the Government's strategy to prosecute the implementation of the Johnson Report recommendations. As such, the fate of the Financial Centre Taskforce may be seen as symptomatic of the commitment to the recommendations of the Johnson Report.

So what of the Financial Centre Taskforce? In the words of it Chair, Mark Johnson, "(t)he Task Force was officially wound up in November 2013 but in effect ceased to operate well before that date due to lack of funding.[45]"

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

5 New Barriers

The 2016 Second Johnson Report set out some new barriers that had arisen in the intervening seven years from the time of the issuance of the Johnson Report. These new barriers focussed on the challenges with the export of financial services, particularly in respect of funds management, and included, from a tax perspective:

- Withholding tax, particularly as it applies to distributions from collective investment vehicles such as Managed Investment Trusts, both in terms of amount and complexity; and
- Treatment of foreign exchange gains and losses within a collective investment vehicle; and
- Multi-currency class investment funds.

Similarly, a number of taxation barriers to the attraction of offshore mobile capital have arisen since the time that the Johnson Report was issued. These are set out below.

5.1 Interest Paid to/From Central Counterparties

As part of its commitment to the G20 derivative commitments, the Government directed market participants to move towards the clearing of OTC transactions, particularly standardised derivatives. That is, a key element of the OTC derivative reform is for derivative positions to be cleared and collateralised through an appropriately structured and regulated Central Counterparty (**CCP**).

An effect of the implementation of these reforms is that there is an increase in interest flows between market participants and CCPs, which may be located outside Australia. Such flows are generally subject to interest withholding tax, even in circumstances where the counterparties to the derivative transaction are both located in Australia or where the counterparty to the Australian participant is an unrelated financial institution located in a jurisdiction that has included an appropriate exemption from interest withholding tax. Accordingly, the implementation of Australia's G20 commitments gave rise to withholding tax for payments of interest from Australia to offshore which previously may not have arisen.

AFMA, the Financial Services Council and the Australian Banker's Association have provided a submission to Treasury which highlighted the potentially market distorting outcomes arising from the imposition of interest withholding tax on collateral posted against centrally cleared derivatives. It was noted in this submission that the market practice in relation to withholding tax is for the paying entity to "gross-up" for the withholding tax, thereby increasing costs for Australian participants. This increased cost would alter pricing of the derivative in a manner so as to render Australian participants as uncompetitive, especially in relation to global transactions. This would affect Australia's ability to be a centre for such transactions and also cause a reduction in government revenue in terms of the profit generated in Australia on such transactions. In making this submission, it was noted that other principal centres for OTC derivative trading, such as the United States, the United Kingdom, Hong Kong and Singapore do not impose withholding tax on interest on collateral posted against derivative positions, rendering Australia as an outlier.

The submission proposed a short legislative amendment whereby interest paid to or from a regulated CCP would be exempt from interest withholding tax. To date, no response has been received from Government.

The issue is one of sufficient gravitas to threaten any aspirations Australia has as a financial centre, and also the competitiveness and profitability of Australia participants. This was noted by the FSI Panel, who stated:

> "Australia's IWT regime also applies to derivative transactions. Under G20 commitments, certain standardised over-the-counter derivatives need to be collateralised and cleared through a regulated central counterparty (CCP). In Australia, outbound interest payments on collateralised positions may be subject to IWT (flows from Australian participants to offshore CCPs, or flows from Australian CCPs to offshore participants). This may increase costs for Australian participants and adversely affect liquidity in Australian derivative markets.[46]"

5.2 Non-Deductibility of Central Costs and the FSE approach

In the section above in relation to the LIBOR Cap, it was noted that the recommendation to abolish the LIBOR Cap was housed within the Board of Taxation Review into the Tax Arrangements Applying to Permanent Establishments. The primary issue considered by this review was to consider advantages and disadvantages of Australia adopting the functionally separate enterprise (**FSE**) approach to the determination of profits attributable to a permanent establishment. As noted by the Board, there are two different approaches that may be used to determine the profits attributable to a permanent establishment, generally under Article 7 or the relevant Double Taxation Treaty or under the domestic law, namely:

- The relevant business activity (**RBA**) approach, whereby the profits of the enterprise, that is the profits arising from third party dealings, are allocated to the relevant permanent establishments that participated in the business that gave rise to the profits; and
- The FSE approach, whereby the permanent establishment is considered to be distinct from the rest of the enterprise and able to transact with the enterprise as if it were a separate legal entity[47].

In 2010, the OECD approved a new Article 7 (Business Profits) and related commentary that authorised a new approach to determining the profits attributable to a permanent establishment, one that hypothesises the permanent establishment as a separate enterprise from the enterprise of which it is a part (i.e. adoption of the FSE approach). Australia has, however, not adopted this approach and the attribution of profits to permanent establishments and continues to allocate actual income and expenses using a functional analysis.

A relevant example of the approach adopted in Australia is the lack of clarity around the deductibility of a proportionate allocation of centralised costs for banks operating in Australia at or through a permanent establishment. Where a bank seeks to centralise its liquidity requirements and hold a pool of high-quality liquid assets in a central location, as required by the prudential regulator of the home country, then seeks to allocate the costs associated with holding this pool of assets (with such costs generally being the difference between the cost of funding to acquire the assets and the returns payable by the assets) on an arm's length basis, then the Australian permanent establishment may be denied a

[46] Financial System Inquiry – Final Report," November 2014, pp279
[47] Board of Taxation "Taxation Arrangements Applying to Permanent Establishments," p2

deduction for the amount charged.[48] The basis for the denial is that the branch may not have "incurred" any expense given that the charge is intra-entity. This gives rise to double taxation, where the home jurisdiction also does not allow a deduction for costs that are properly referable to the Australian branch.

The Board's review highlighted many advantages, and some disadvantages, arising from Australia looking to adopt the FSE approach in Australia, although many of the disadvantages were noted by the Board as arising outside of the banking industry and being in the nature of enhanced compliance costs for small and medium enterprises. As such, the Board canvassed the possibility to "adopt the FSE for financial institutions. This could be done through modernisation of the *Income Tax Assessment Act 1936* which would include its extension to Australian financial institutions and increasing the scope of the provision to cover financial arrangements.[49]"

In making this observation, the Board noted that:

> "to the extent that some of Australia's top two-way trading partners also adopt the use of the FSE approach in practice for the purpose of allocating profits to [permanent establishments], it (being the adoption of the FSE approach in a banking context) would assist the goal of Australia being a financial centre as it would be consistent with that practice."

Of the jurisdictions that have lodged a reservation against the adoption of the FSE approach in Article 7 of the model treaty only one, namely New Zealand, is a top 10 two-way trading partner with Australia[50][51].

Unfortunately for Australia's aspirations as a financial centre, the Government is yet to release any comment in relation to the Board's review. Hence, at a macro level, inconsistency of approach in terms of the determination of profits attributable to a permanent establishment stymies the extent to which Australia may become a financial centre. This is particularly the case where the application of the current approach results in potential double taxation in respect of regulatory costs, such as costs associated with adhering to liquidity requirements.

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[48] Refer ATO ID 2012/92. "Deduction: interest expense to fund general reserve liquid assets."

[49] Board of Taxation "Taxation Arrangements Applying to Permanent Establishments," p3

[50] Australia's top 10 two-way trading partners are: China, Japan, the United States, Korea, Singapore, New Zealand, the United Kingdom, Malaysia, Thailand and Germany. Refer http://dfat.gov.au/trade/resources/trade-at-a-glance/pages/default.aspx

[51] The jurisdictions that have lodged a reservation against the FSE approach in Article 7 of model Treaty are: New Zealand, Chile, Greece, Mexico, Turkey and Portugal. Refer "Commentaries on the Articles of the Model Tax Convention," OECD, p153.

6 Concluding Comments

The Johnson Report outlines an integrated package of recommendations designed to promote Australia as a financial centre. The motivations for the recommendations, namely to promote the export of financial services and to enhance the competitiveness of local business, have been agreed by both sides of government and remain as relevant today as they were in 2009. It is somewhat of a surprise, therefore, that progress of implementation of the recommendations has been tediously slow. Even more surprising is the lack of clarity as to whether there is even conceptual support for some of the recommendations.

Granted, there has been some progress in terms of implementation, particularly to support the export of financial services. Such progress has immediate impact in enhancing Australia's position as a financial centre – our ranking in the Global Financial Centre Index is on an upward plane and investment by foreign fund managers into Australian trusts has doubled over the last five years.

Disappointingly, however, the progress on other recommendations has stalled, to the point where stakeholders are questioning commitment from government. This paper highlights three specific taxation recommendations that continue to be endorsed by a raft of government-initiated enquiries but in relation to which progress in terms of implementation has been limited at best.

Of equal concern has been the dismantling of the structure put in place to ensure connectivity between industry and government to identify future barriers and to ensure that the policy settings address such barriers in a manner that keeps Australia competitive. The world continues to evolve and the needs of users will adapt to such evolution. The absence of an effective bridge between such users and those that control Australia's policy settings is particularly concerning as new barriers emerge.

In terms of taking the issues raised, both in this paper and in the Financial Services Council's Second Johnson Report, the following should occur:

- The Government needs, as a matter of urgency, to issue a response to the Board of Taxation Review into the Tax Arrangements for Permanent Establishments. This would provide stakeholders, such as AFMA and its members, of the Government's perspectives both on the potential advantages of Australia adopting the functionally separate enterprise approach and also in terms of the recommended abolition of the LIBOR Cap;
- The Government should request the Board of Taxation to review the taxation observations made in the Final Report of the Financial System Inquiry. Given that the terms of reference for the FSI precluded recommendations on taxation matters, and the subsequent abandonment of the Tax White Paper process, without further consideration these observations will be in vain. The review should encompass the impacts of removing interest withholding tax for financial institutions and the Government needs to provide clarity as to its policy position on this issue;
- There ought to be a further review of the OBU regime, building on the 2015 amendments and those outstanding Johnson recommendations, but also highlighting additional issues and concerns that have arisen in the intervening period; and
- The Financial Centre Taskforce, or a body of similar standing and authority, needs to be reinvigorated. This could be done through an industry body such as AFMA providing the secretariat and other support and bringing the key industry stakeholders together.

In terms of assessing the performance of successive governments to prioritise and implement the recommendations of the Johnson Report, the comment that particularly resonates is that from Mark Johnson and fellow AFCF member Geoff Weir. In their combined submission to the FSI, Mr Johnson and Mr Weir state:

> "This submission reflects the authors' personal experiences working with the Financial Centre Forum and the Financial Centre Task Force. It is provided on the basis that neither of the authors would wish to be involved in any future initiatives along the lines suggested."

It is incumbent on the Government to remedy this disillusionment.