Improving the Offshore Banking Unit regime

Discussion Paper
June 2013

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Request for feedback and comments

The Government seeks your feedback and comments on the issues outlined in this discussion paper. As this paper provides details about how these proposals could be legislated, you may wish to comment on law design as well as policy design issues in your submission. It would assist the consultation process if stakeholders who have concerns with the proposals could provide practical examples in their submissions demonstrating the implications of these proposals and how alternative approaches could operate.

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Closing date for submissions: 19 July 2013

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Foreword

On 14 May 2013, the Government announced a number of measures to ensure Australia's corporate tax system remains fair, competitive and sustainable by closing business tax loopholes.

The announcement included changes that will address integrity issues with the offshore banking unit (OBU) regime and better target the regime to genuinely mobile financial services activity.

This paper discusses these changes and other matters concerning the operation of the OBU regime that were raised in the Johnson report.

Following the announcement of this measure, consultation including through the Corporate Tax Sustainability Roundtables has taken place. A particular concern was the imminent start date of 1 July 2013. To address this concern the Government has decided to delay the start date until 1 October 2013.

I encourage all stakeholders who have an interest in the proper operation of the OBU regime to provide comments on this discussion paper. The Government will give serious consideration to all comments that will help to be address integrity issues with the regime and to ensure Australia continues to develop as a leading financial services centre.

The Hon David Bradbury MP
Assistant Treasurer

1. BACKGROUND

A limited offshore banking unit (OBU) regime was introduced into the income tax law in 1987 to provide an exemption from withholding tax on interest paid on eligible foreign borrowings of an OBU. In 1992 the OBU regime was extended to provide a concessional rate of tax of 10 per cent for certain income from eligible activities of an OBU.

Initially, the regime applied only to banks and foreign exchange dealers. It was further extended in 1999 to include insurance companies, fund managers and other companies the Treasurer determined to be an OBU.

In 2009 the Australian Financial Centre Forum's report *Australia as a Financial Centre: Building on our Strengths* ('the Johnson report') made a number of recommendations to reform the OBU regime. The report argued that these proposals would enhance the capacity of Australian banks and other financial services companies to engage in a wider range of cross-border financial transactions from Australia.

More recently the Government has become concerned that the OBU regime is being used to transfer domestic banking activities and non-banking profits into OBUs. As part of the 2013-14 Budget the Government announced it would amend the OBU provisions to better target genuine mobile financial sector activities and address integrity issues.

The Government also announced that it would consult with industry regarding concerns about the allocation of expenses between offshore banking (OB) activities and non-OB activities and issues raised in the Johnson report.

Since the Government's announcement, initial consultation has occurred with industry, including an industry roundtable consultation meeting.

2. Policy intent and Background

The OBU regime was established to encourage the development of offshore banking in Australia.

When introducing the OBU interest withholding tax exemption for OBUs in 1987, the then Treasurer stated that the exemption was 'intended to encourage offshore transactions and in particular on lending to non-residents'.[1]

The concessional income tax rate for OBUs was announced in 1992. As part of the announcement, the then Prime Minister stated that 'a 10 per cent rate for profits from offshore banking will provide further stimulus to the development of offshore banking in Australia at a time when such activity might be shifted from Hong Kong to elsewhere in the Pacific'.[2]

The Johnson report noted that the purpose of the provisions was 'to encourage offshore financial transactions between non-residents to be conducted by an Australian institution rather than by an offshore financial institution'.[3]

To ensure that income from domestic banking activities do not benefit from the concessional tax treatment the OBU regime seeks to limit the concession to entities declared to be an OBU and to income from eligible activities. Furthermore, the regime requires the proper allocation of expenses between OB activities and non OB activities. These rules have proven to be ineffective or unclear in some circumstances.

3. Problems with the current regime

Under the OBU regime an entity that is an OBU is subject to an effective rate of tax of 10 per cent on income from eligible activities. Other income of the entity is taxed at the normal company tax rate of 30 per cent. This difference in tax rates has led to some taxpayers engaging in arrangements that inappropriately access the concessional 10 per cent rate, including through the recharacterisation of ineligible income.

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1 Explanatory Memorandum to Taxation Laws Amendment Bill (No.5) 1987.

2 One Nation, Statement By Prime Minister The Honourable PJ Keating, 26 February 1992.

3 At page 57.

At the same time industry has argued that the OBU regime has not been fully utilised because of uncertainty surrounding its operation and its scope. These issues were identified in the Johnson report, which made a number of recommendations to address these concerns.

Following on from the Government's announcement, this paper outlines and seeks comments on the following issues:

- inappropriate access to the OBU concession;
- the 'choice' principle;
- list of eligible OB activities;
- allocation of expenses between OB income and non-OB income;
- streamlining the OBU application process;
- ensuring other provisions interact appropriately with the OBU regime; and
- treatment of existing transactions.

3.1 Inappropriate access to the OBU concession

Cases have been identified where the OBU provisions have been used to access the concessional 10 per cent rate for income from activities that are in substance not eligible OB activities. In other instances, the provisions have been used to ensure that income or gains are attributed to the OBU while deductions or losses are allocated to the domestic bank, providing an effective arbitrage between the different tax rates.

Three particular types of arrangements have come to the Government's attention:

- related party transactions that have the effect of converting non-OB income to OB income;
- transactions transferred between an OBU and other parts of the entity so that gains are attributed to the OBU while losses are attributed to domestic bank; and
- trading in shares or securities issued by a related party that has the effect of converting non-OB income to OB income, such as the sale of significant overseas non-banking assets via the sale of shares in a non-resident subsidiary.

There is also concern that OBUs could be used to fund offshore subsidiaries with any interest income received from the subsidiary being inappropriately taxed at the concessional 10 per cent rate.

The Budget announcement proposes to address these concerns by making all dealings with related parties and any transactions which are transferred between an OBU and the non-OBU part of the business, ineligible for OBU treatment.

In initial consultations following the Government's announcement (including through the industry roundtable consultation meeting), industry has raised concerns about the proposal to deny OBU treatment for all related party transactions. Participants in the consultation said this proposal will, in addition to preventing transactions which are of genuine concern, capture genuine mobile activities that should be able to attract the OBU concessional rate.

Stakeholders have said that any changes should better target transactions that give rise to integrity concerns, arguing that:

- preventing an OBU from dealing with related parties would mean that a bank that was an OBU would require separate treasury functions, which would be inconsistent with the normal way banks centrally manage their funding requirements and credit exposures; and
- any mischief from related party dealings could only occur from investment transactions and not from funding arrangements.

Consultation questions:

1. What would be the impact of this proposal on OBU activity? Could you please provide any examples which illustrate this impact.

2. What, if any, other approaches would better address the integrity concerns?

The current OBU provisions also allow an OBU to transact with another OBU. Permitting such transactions to access the concessional rate is not consistent with the policy intent of the regime as OBU to OBU transactions are essentially domestic transactions.

The Government proposes to exclude these transactions from accessing the concessional rate of tax under the OBU regime.

Consultation question:

3. What would be the impact of this proposal on OBU activity?

3.2 The 'choice' principle

This issue concerns whether a taxpayer that is an OBU can choose to book eligible OB activities against their OB business or their non-OB business. According to the Johnson report, industry has long interpreted the determination TD93/135 as providing OBUs with a choice as to whether to book eligible transactions to the domestic operations or to the OB operations.

Industry claims that, without the ability to choose whether to book transactions to the OBU or to the domestic account, the OBU regime would be unworkable. For example, stakeholders said that if taxpayers were unable to choose how they treat eligible OB activities, the OBU interest withholding tax exemption would apply to all offshore borrowings of an entity that is registered as an OBU. This would then result in that entity becoming liable to pay the withholding tax penalty when it transfers funds raised from an offshore borrowing other than by way of an OB activity. Industry also claims that, in the absence of choice, compliance costs would be increased.

Further, an ATO consultation document in 2007 suggested that tax determination TD 93/135 may be withdrawn. This has led to uncertainty regarding the legislative authority underpinning this interpretation.

To provide certainty and ensure that the OBU regime operates properly, especially in circumstances where an entity has both OB income and non-OB income, it may be appropriate for the legislation to provide for an OBU to choose to book transactions to either its OB activities or non-OB activities.

However, such a choice should not come at the expense of the integrity of the regime. To address integrity concerns, the choice would be required to be made at the time of entering into the relevant transaction and would be irrevocable. An exception would be available to correct mistakes made in the course of accounting for an OBU transaction. That is, if an OBU transaction is entered into the non-OB accounts through a mistake or error, it could be corrected.

Consultation questions:

4. Would this approach address uncertainties regarding the application of the choice principle? If not, how can the uncertainty be addressed?

5. Would this approach strike the right balance between the effective operation of the OBU regime and the regime's integrity?

3.3 List of eligible OB activities

There is a wide range of activities which have been made eligible for OBU treatment. These activities are:

- borrowing or lending activities;
- guarantee-type activities;
- trading activities;
- eligible contract activities;
- investment activities;

- advisory activities;
- hedging activities; and
- any other activity declared by regulations to be an OBU activity (to date no other activity has been declared).

This list was last updated in 1999. The Johnson report concluded that the list and descriptions of eligible OB activities in the tax law were out of date and unclear and recommended that the list be updated. Although the report also recommended the list be regularly reviewed and updated, it did not include a recommendation on how to refine the list of eligible OB activities.

Consultation question:

6. How can the current list of eligible activities be refined to better serve the policy intent of the regime? Please explain how any new activities will attract highly mobile activities to Australia.

3.4 Allocation of expenses between OB income and non-OB income

The Government announced as part of the 2013-14 Budget that consultation would be undertaken on whether expenses are appropriately allocated between OB income and non-OB income. The inappropriate allocation of expenses can reduce the effectiveness of the OBU regime.

Broadly, under the current rules the allocation of deductions between OB income and non-OB income depends on whether a deduction is classified as an exclusive, a general or an apportionable deduction.[4] Exclusive deductions are allocated exclusively to OB or non-OB income based upon the relevant facts. General and apportionable deductions are allocated according to the relevant legislative formulae.

Concerns have not been raised regarding the treatment of exclusive deductions. However, industry has argued that the general OB deductions rule is complex and cumbersome and delivers distorted and arbitrary expense allocations. Industry has proposed that the expense allocation rules for the OBU regime should accord with economic principles and result in the fair and reasonable allocation of expenses.

Also, concerns have also been raised about the apportionable deductions rule and the treatment of deductions that do not relate to either OB income or non-OB income.

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4 An apportionable deduction is defined in subsection 995-1(1) of the *Income Tax Assessment Act 1997*.

Consultation questions:

7. Are there any concerns regarding the treatment of exclusive deductions? If so, what are they?

8. How should general deductions be allocated? If the allocation rules were to change, what would be a fair and reasonable way to allocate the expenses?

9. How should apportionable deductions be allocated?

3.5 Streamlining the OBU application process

The Johnson report stated that the process for assessing OBU applications can be complex and extremely slow, particularly for applicants in the 'other company' category. Applicants under this category are subject to a determination by the Treasurer or Assistant Treasurer and are required to provide information to be taken into account in making that determination. The Johnson report recommended a streamlined process for vetting new OBU applications:

- with a requirement that an application be approved or denied within six months of its receipt, subject to all of the appropriate application material being lodged; and
- that information provided by an applicant under the 'other company' category is verified by an external auditor (or equivalent).

Consultation question:

10. What are the main concerns with the application process? How can this process be improved?

3.6 Ensuring other provisions interact appropriately with the OBU regime

While the OBU regime provides a concessional tax rate it relies on other provisions of the income tax law to determine what constitutes assessable income and allowable deductions. In addition the consolidation rules may operate so that the head company of a consolidated group (and therefore the whole group) is treated as an OBU. Therefore, the proper interaction with other provisions is important.

Consultation question:

11. Are there any inappropriate outcomes that arise as a result of the interaction of the OBU regime and other provisions in the income tax law? If so, how can they be resolved?

3.7 Treatment of Existing Transactions

The changes to the OBU regime as announced in the Budget were to apply to income years commencing on or after 1 July 2013. However, following initial industry consultation the Government has decided to defer the start date until 1 October 2013 (See Assistant Treasurer's press release No. 128 of 28 June 2013).

Existing transactions will not be grandfathered. Consequently, income earned on or after 1 October 2013 on transactions that do not qualify for OBU treatment will be ineligible for the concessional 10 per cent tax rate, irrespective of when the transaction was entered into.

During the initial consultation, stakeholders raised concerns that these changes could have the unintended consequence of an OBU breaching the OBU 'purity test'. If the purity test is breached, the OBU will be excluded from the tax concession in the income year of the breach.

Details of how taxpayers may be adversely affected through the operation of the purity test following the proposed changes will assist in this issue being properly considered.

Consultation question:

12. How could taxpayers be adversely affected through the operation of the 'purity test' and the proposed changes to the OBU provisions?

13. How could these any unintended consequences be addressed?