Written Question on Notice

Question: Please provide any further information on benchmarking interest withholding tax with other jurisdictions.

Interest Withholding Tax Treatment in Comparable Jurisdictions

Please find some information regarding the imposition and relevant exemptions of interest withholding tax in Singapore, Hong Kong, the UK and the USA.

Singapore

Singapore does have a withholding tax regime for payments of interest from a Singapore borrower to a non-resident lender. However, there is currently an exemption for payments made by banks, finance companies and other approved entities, being those licensed to deal in financial market products, advising on corporate finance, underwriting debt/equity issuances or otherwise approved by the MAS. In addition, all interest payments by Singapore bank branches to head office/other branches are exempt from withholding tax.

From a products perspective, there is currently a withholding tax exemption for payments on structured products and OTC derivatives offered by a financial institution in Singapore to a non-resident that is not an individual and

These exemptions are designed to position Singapore as an attractive destination for banks and qualifying entities to set up operations in Singapore.

Hong Kong

Hong Kong does not impose interest withholding tax on payments of interest from a Hong Kong borrower to a non-resident lender.

United Kingdom

The UK does have a withholding tax regime for payments of interest from a UK borrower to a non-resident lender. However, there are several relevant exemptions:

- Payments of interest to or from a UK bank (or a UK PE of a foreign bank);
- Payments of "short" interest, i.e. payments of interest on a loan with a term of less than a year;
- Payments of interest on a quoted Eurobond.

United States of America

The USA does have a withholding tax regime for payments of interest from a US borrower to a non-resident lender. There is an exemption for payments on obligations with less than 183 days duration, payments of interest on bank deposits and also for "portfolio" interest, which requires the following to be satisfied:

- Interest is paid on debt that is in registerable form;
- The payee does not own more than 10% of the payer;
- The non-US lender is not a bank.

AFMA Policy Position

To assist the Committee in the preparation of the second interim report, please find attached AFMA's 2021/22 Pre-Budget submission which includes, as Appendix A, the submission lodged by AFMA in August 2020 to the October budget for the 2020/21 year. Attachment A1 to this submission sets out AFMA's policy submission with respect to interest withholding tax, including our recommendation (which mirrors the Johnson Report recommendation) to:

- 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; and
- Remove withholding tax on financial institutions' related party borrowing.

As mentioned to the Committee in testimony, interest withholding tax is immaterial in terms of revenue given the current historically low interest rate environment, the current exemptions in Section 128F and the increasing network of double tax treaties that include an interest withholding tax exemption for payments to unrelated financial institutions. Better alignment of the interest withholding tax exemptions with key competitor jurisdictions will assist Australia in enhancing its position as a Finance and Technology Centre.

29 January 2021

Budget Policy Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Via email: prebudgetsubs@treasury.gov.au

Dear Treasury

2021/22 Pre-Budget Submission

The Australian Financial Markets Association (AFMA) represents the interests of over 120 participants in Australia's financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. They are the major providers of wholesale banking and financial market services to Australian businesses and investors.

We are pleased to provide a submission to Treasury to assist in the formulation of the Government's 2021/22 Federal Budget.

1. Australia's Financial Sector Competitiveness

Following the deferral of the 2020/21 Federal Budget to October 2020, AFMA provided Treasury a supplementary Pre-Budget submission in August 2020, a copy of which is attached as **Appendix A**. This submission highlighted the strong performance of Australia's financial markets during the COVID-19 pandemic and the importance of the financial markets in supporting Australia's economic recovery. In this context, our submission recommended the inclusion of specific measures in the 2020/21 Budget to both support robust economic recovery and enhance Australia's attractiveness as a location for the conducting of financial business. Specifically, the submission noted that financial services can contribute to increased economic growth on a sustained basis through two primary means:

1. Providing high quality, innovative and cost-effective financial intermediation and risk management services to Australian businesses, governments and consumers; and
2. Operating as an international financial centre, by providing services to overseas clients and generating employment, income and tax revenue in Australia.

The 2020/21 Federal Budget had as its principal focus Australia's immediate economic response to the COVID-19 pandemic, and consequently the measures recommended by AFMA in its

Australian Financial Markets Association
ABN 69 793 968 987
Level 25, 123 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7955 Fax: +61 2 9776 4488
Email: info@afma.com.au Web: www.afma.com.au

submission were not part of the Government's budget. It is AFMA's view that the recommended measures remain fit for purpose and, indeed, have enhanced in importance, due to an increase in competition from other jurisdictions for mobile financial business. For example, Japan has recently committed "to making its capital markets more attractive with strategic initiatives and to creating an environment that attracts foreign businesses and highly-skilled foreign professionals.[1]"

The COVID-19 pandemic has been a catalyst for many financial system participants to consider where to conduct mobile financial centre activities. This should represent a significant opportunity for Australia to capitalise on its relative strengths, such as adherence to the rule of law, political and economic stability (at a time where such stability is not as apparent in competing regional financial centres), quality of life and access to talent to enhance the proportion of mobile financial busines that is conducted in Australia.

However, considerable barriers to conducting business from Australia have caused our relative attractiveness as a financial centre to fall in recent times. Based on the latest report of the Global Financial Centres Index from September 2020, a ranking of the competitiveness of financial centres, Melbourne ranks 27th and Sydney 32nd, with eight Asian financial centres ranked above them, including five in the top seven. Such rankings may be compared to 2017 when Sydney was ranked 8th globally.

In AFMA's view, the sharp decline in the attractiveness of Australia's financial centres is largely a consequence of the lack of focus by successive Governments on ensuring that settings conducive to attracting financial business to Australia remain current and consistent with competing jurisdictions. Competing financial centres have improved their offering to global firms, while Australia has, at best, been static. Indeed, the last concerted effort to improve Australia's attractiveness was the 2009 Johnson Report into Australia as a Financial Centre, many of the recommendations of which Report remain unimplemented, despite receiving bipartisan support.

As such, it is crucial that the Government should commit in the 2021/22 Federal Budget to address the shortcomings in our policy settings that hinder the attractiveness of Australia as a financial centre. The absence of such a commitment from the Government would further harm Australia's ability to attract mobile financial business at a pivotal time where firms are actively deciding the locations from which to conduct such business in the future.

General Recommendation

The Government should work with the industry to develop a 'post-Johnson review' growth agenda for financial markets that is centred on reform measures to promote cost effective services, competition and international competitiveness. The objective should be to keep and grow businesses in Australia.

To commence this process, the Government should immediately establish a Financial Centre Taskforce comprised of industry and official sector representatives who have the experience and authority to confirm and prioritise the components of a Financial Centre Development Plan. The Taskforce should operate under the auspices of the Treasurer and progressively report to the Treasurer within a period of months.

[1] Financial Services Agency of Japan, "The Financial Market Entry Office," January 12, 2021

The outcome should be a comprehensive industry development plan for financial markets, to optimise their role in the national economy and enhance Australia's competitiveness as a financial centre. The required financial commitment in the Budget to implement this recommendation would be minimal.

Specific Recommendations

In addition to the establishment of the Financial Centre Taskforce and the formulation of the development plan, the Government should commit to a number of specific measures in the 2021/22 Budget to arrest the decline in Australia's attractiveness as a financial centre. These include:

- Commitment to the abolition of non-resident interest withholding tax on borrowings by financial institutions, as recommended by the Johnson Report into Australia as a Financial Centre and the Henry Tax Review;
- Confirmation that the Government will maintain taxation settings that provide a tax competitive outcome for international financial centre business, in light of the OECD's ongoing review into the Offshore Banking Unit (**OBU**) regime;
- Immediate abolition of the 'LIBOR-cap' on deductible interest expense for cross-border intra-branch funding prior to the cessation of LIBOR in 2021; and
- Adjustment of financial regulator cost recovery models to be fairer, more consistent, administratively efficient and reflective of the public benefit from regulation at least to some degree.

These measures would also benefit the economy by boosting competition in financial markets and broadening the funding base for Australian entities. Further detail in relation to each of these recommendations is contained in the Appendix.

2. Setting Financial System Policy to Support Economic Growth

The Government determines the policy settings for the financial system in accordance with the evolving needs of the community. Since it has multiple policy objectives that are at times conflicting, policy implementation measures must be calibrated to serve the Government's related priorities. Thus, the Government must communicate to regulators how this prioritisation should be reflected in the way they administer the law. If this process works well, it will support economic growth. If it is deficient, it can act as a brake on innovation and economic growth.

Following the COVID-19 outbreak, AFMA observed clear signalling by the Government that it expected regulators to administer the law in a manner that would facilitate commercial activity and economic growth. Complementing this, the Department of the Treasury exerted greater policy influence with more attention given to measures to support the economy. The financial regulators responded by rebalancing of their priorities, so a pre-existing overriding emphasis on eliminating risk of consumer harm was tempered by a greater focus on the need to support economic activity. This meant that the regulatory regime for financial services operated in a more pragmatic and efficient manner.

Several points flow from this in the design of long-term change that will support the economy:

- The Government must insist through Statements of Expectations and other communications to the regulators that they give proper regard to its economic growth and competitiveness objectives in their administration of the law. Absent this, recent gains in the quality of regulation will be lost and the shift to better balanced regulation that incorporates broader community welfare measures, beyond consumer protection, will be transitory and reversed once the crisis conditions dissipate.

- The proposed Financial Regulator Assessment Authority must be equipped to complement Government and Parliamentary oversight by providing an effective ongoing review process that includes quality of policy implementation. This will help to ensure the Government's objectives are well served in the way that does not hinder the effectiveness of regulators and promotes the confident participation of the community in the financial markets.

- The Treasury needs to operate as the key policy adviser to the Government on financial system regulation, so the Government is better positioned to make decisions that support sustainable economic growth.

Naturally, policy requires adjustment over time, so the Government must regularly update its strategic priorities for the financial regulators and communicate its related expectations of them in a manner that is clear, capable of assessment and promotes a sound mutual understanding of these priorities.

The approach suggested here may seem obvious, but it has not always been adopted. The COVID-19 response demonstrates that financial regulation can operate in a way that supports economic growth without compromising core regulatory objectives. Taking this approach going forward would help to ensure that financial entities are regulated in a proportionate and predictable manner, which would support innovation and business activity. The associated revenue flow would improve the Government's fiscal position in the short and long term.

* * * * *

Thank you for the opportunity to contribute to the Government's consideration of matters that should be addressed in the 2021-22 Federal Budget. We would be happy to discuss any of the matters that we have raised in this submission.

Yours sincerely,

Rob Colquhoun
Director, Policy

Appendix A – AFMA 2020/21 Pre-Budget Submission

24 August 2020

Budget Policy Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Via email: prebudgetsubs@treasury.gov.au

Dear Treasury

Financial Markets Supporting Economic Recovery - October Budget Submission

The Australian Financial Markets Association (AFMA) represents the interests of over 110 participants in Australia's financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. They are the major providers of wholesale banking and financial market services to Australian businesses and investors.

We are pleased to have the opportunity to further contribute to the Government's planning process for the October Federal Budget.

Given the severe economic impact of the COVID-19 pandemic, the focus of the October Budget needs to be on economic recovery and placing the Australian economy on a firm growth path. This will require broad-based economic reforms to stimulate a lift in productivity and strengthen our international competitiveness.

1. Financial Markets and Economic Growth

The stability and resourcefulness of the financial sector has been a shock absorber helping the Government alleviate the worst economic effects of COVID-19 to date. Looking through the forward lens of the Budget, the financial markets can play a vital role in supporting robust economic recovery. Economic growth is contingent on the effective allocation of our nation's resources. Efficient financial markets allocate capital and risk in accordance with economic needs, within the parameters of official market interventions.

Financial services can contribute to increased economic growth on a sustained basis through two primary means:

3. By providing high quality, innovative and cost-effective financial intermediation and risk management services to Australian businesses, governments and consumers; and
4. By operating as an international financial centre providing services to overseas clients and generating employment, income and tax revenue in Australia.

Both pathways to supporting economic growth depend on the ingenuity, enterprise and capacity of market participants. As a highly regulated industry, performance also depends significantly on the effects of government regulation and taxation. Official intervention in markets, such as through yield curve control, can assist growth and influence activity on a transitory basis.

Australia is well placed in respect of the quality, sophistication and general efficiency of its financial markets. However, the exceptional growth in regulation of financial markets over the last decade has absorbed resources and capital, directing them away from productive activities. Regulatory risk aversion has increased, which is counterproductive to innovation and enterprise. Effective regulation is vital to the success of financial markets and the policy challenge is to achieve its purpose in a way that minimises the related costs and risks for market participants.

International trade and investment are important factors in Australia's economic success and there is great potential to grow income and employment through international financial services business. The openness of Australia's financial system and broader economy needs to be maintained to facilitate development of the national economy, including by promoting competition in the financial system.

Our international competitiveness as a financial centre presents a disappointing picture, as Australia has underperformed relative to its potential in this area and has declined in international ratings. Governments have previously developed policy ideas to produce better economic outcomes for Australia; for example, the Howard Government's 'Australia - a Regional Financial Centre' initiative' in 1997, or Mark Johnson's Australia as a Financial Centre Report in 2009. However, they failed to execute recommended measures efficiently, or at all in some cases, while jurisdictions like Singapore moved more deftly to out-compete Australia and enhance their standing as a regional financial centre.

Sydney is ranked at number 20 in the March 2020 Global Financial Centres Index (GFCI), with 7 Asian centres ranked above it (and 5 in the top 7).[2] The GFCI questionnaire asks respondents which centres they consider will become more significant over the next two to three years; nine of the top 15 centres cited are in the Asia-Pacific region, with none from Australia.

Senator Andrew Bragg has correctly drawn attention to the transitory opportunity for Australia presented by geopolitical developments in Hong Kong. Singapore and other centres like Tokyo are actively competing for this business, while Australia has been static and uninterested. AFMA believes Australia still has potential to be a vibrant international financial centre, but to achieve this the Government would need to show a genuine commitment to put in place, and then maintain, a competitive tax and regulation environment. Indeed, it would be wrong to think about this only in terms of attracting new businesses, as absent this kind of commitment, Australia faces a material risk of losing some business currently being done here to competing centres in the region.

[2] The *Global Financial Centres Index* is a ranking of the competitiveness of financial centres and is widely quoted as a source for ranking financial centres.

1.1 Examples of Issues that Inhibit Economic Growth

The table below summarises some of the key competitiveness barriers to Australia being successful as an international financial centre. As might be expected, these factors more generally inhibit the financial sector's capability to fully support economic recovery from the impact of COVID-19. The 2020/21 Budget provides the opportunity to address these issues, with some suitable for reform action this year and others forming part of a longer-term strategy.

Barriers to Australia's Competitiveness as an Investment Location and Financial Centre

Barrier	Issue	Official Reports Supporting Change
Taxation and Levies		
High corporate tax rate	A disincentive to investment and harder to attract capital and business to Australia.	Henry Tax Review
Complex tax law and administration	Increases cost of doing business in Australia and reduces attractiveness of Australia as a place to do business.	
Financial institution non-resident interest withholding tax	Increases cost of finance for Australia and inhibits its competitiveness for cross- border business.	Johnson Report Henry Tax Review Senate Standing Committee on Economics
'LIBOR cap' on cross border intra-bank funding	Increases tax compliance costs and inhibits competition in banking.	Johnson Report Board of Taxation Senate Standing Committee on Economics
OBU regime	Limited utility of regime and uncertainty about its future risk current jobs and tax revenue.	Johnson Report
Regulator cost recovery ASIC levy, AUSTRAC levy	High cost of levies and business impacts from their design deter financial trading in Australia.	
Permanent establishment (branch) taxation	Australia is out of step with international practice that recognises separate entity treatment.	Board of Taxation
Regulation and Other Issues		
Regulatory policy and implementation	Insufficient priority is given in financial regulatory policy to supporting the economy and international competitiveness. Policy design often does properly balance economic regulation objectives. Excessively complex regulatory solutions.	Hayne Royal Commission criticised regulatory complexity
ASIC regulation	Increasing grey areas in ASIC's distinction between wholesale and retail clients. ASIC regulation of overseas financial service providers is a barrier to the conduct of wholesale business in Australia.	G20 Commitment on Harmful Fragmentation IOSCO Taskforce on Cross Border Regulation
IT and human resources	Limited availability of top-class IT talent is a constraint to the growth of high-tech business in Australia.	

The above list is not exhaustive, but it does illustrate the range of issues that require attention in the Government's budgetary planning for recovery in economic growth. These are not theoretical issues; rather, they currently have direct trade and investment implications, as illustrated by the analysis in the July 2020 City of London Report on *Australia-UK Cross Border Trade in Financial Services.*[3]

This Report outlines a range of Australian tax and regulatory rules that impede trade in financial services with the UK, which would also apply more widely to other jurisdictions. For example, ASIC's new Foreign Financial Services Provider (FFSP) licensing regime inserts a significant barrier to the conduct of cross-border business between Australian wholesale clients (including large companies and financial institutions) and financial service providers based overseas. It is a legally complex and very costly task for overseas providers to scale the regulatory wall between them and Australian wholesale clients and this will result in some overseas services being reduced or withdrawn completely.

These issues matter because, as a developed, open economy whose financial markets are integrated with global markets, business in Australia will want to deal with financial entities located overseas. Doing so provides diversification in investment and funding, access to better prices in the most competitive markets, new business opportunities and better integrated services for firms in Australia that have significant global operations.

1.2 Budget Actions Targeting Economic Growth

The Treasurer, Josh Frydenberg, in his Press Club address on 5 May 2020, set the right tone for the Government's long-term economic planning when listing the values required to support economic recovery, including encouraging personal responsibility, maximising personal choice, rewarding effort and risk taking whilst ensuring a safety net which is underpinned by a sense of decency and fairness.

Individuals and businesses react to economic incentives. The Government should rely on the processes constituting a market-based economy to allocate resources within the economy. Government intervention in the economy should be no more than the level required to address market failures and to support the social fabric that underpins a stable society.

2. AFMA's strategic policy level recommendation

The Government should work with the industry to develop a 'post-Johnson review' growth agenda for financial markets that is centred on reform measures to promote cost effective services, competition and international competitiveness. The objective should be to keep and grow businesses in Australia. The diversity of cost-effective product and service options that this would provide to users of the financial system would support economic productivity and development. Such an agenda could, for example, include measures to promote development of the domestic corporate bond market.

To commence this process, the Government should immediately establish a Financial Centre Taskforce comprised of industry and official sector representatives who have the experience and authority to confirm and prioritise the components of a Financial Centre Development Plan. The Taskforce should operate under the auspices of the Treasurer and progressively report to the Treasurer within a period of months.

The outcome should be a comprehensive industry development plan for financial markets, to optimise their role in the national economy and enhance Australia's competitiveness as a

[3] https://www.cityoflondon.gov.uk/assets/Business/UK-crossborder-trade-in-services-with-Australia.pdf

financial centre. The required financial commitment in the Budget to implement this recommendation would be minimal.

3. Direct measures in the 2020/21 Budget

Industry confidence in the Government's commitment to a Financial Centre Development Plan is key to its success. The 2020/21 Budget should include measures to promote this including:

- Abolition of non-resident interest withholding tax on borrowings by financial institutions;
- Confirmation that the OBU regime will be either retained or replaced with an alternative arrangement that provides a similar outcome for international financial centre business;
- Immediate abolition of the 'LIBOR-cap' on deductible interest expense for cross-border intra-branch funding; and
- Adjustment of financial regulator cost recovery models to be fairer, more consistent, administratively efficient and reflect the public benefit from regulation to some degree.

These measures would also benefit the economy by boosting competition in financial markets and broadening the funding base for Australian entities.

4. Additional measures

The Attachment to this letter provides more information on the above issues and includes recommendations for taxation and regulation measures to remove a range of other barriers to the financial markets more fully supporting economic recovery.

In respect of policy and regulation, the recommendations include:

Better Policy Making for Financial Services

- Introduce a more systematic government approach to policy development; and
- Ensure that regulation is proportionate and clearly distinguishes between wholesale clients and less sophisticated retail clients as intended under the *Corporations Act*.

Smarter Regulation

- Establish the proposed Financial Regulator Assessment Authority and provide it with resources and a mandate that enable it to support a high standard of regulation;
- Require regulators to provide clear, readily accessible guidance to regulated firms; and
- Introduce a test case scheme for ASIC that is based on the same principles as ATO's test case scheme and that operates in accord with ASIC's organisational structures.

Most recommendations, including central reforms to improve the policy and regulation process, would entail a small funding commitment in the context of the Commonwealth Budget, but they would deliver material benefits to the national economy.

Thank you for the opportunity to contribute to the Government's consideration of matters that should be addressed in the 2020-21 Federal Budget. We would be happy to discuss any of the matters that we have raised in this submission.

Yours sincerely,

ATTACHMENT

A1 - Implement Interest Withholding Tax Reform

Recommendation

The Government should announce the abolition of interest withholding tax on offshore funding by financial institutions, as recommended by the Johnson and Henry Tax Review reports and acknowledged in the Financial System Inquiry report.

This reform would remove a tax barrier to cross-border finance, reduce pressure on the cost of finance in the economy and assist competition. It would be a timely reform as the direct Budget cost of the reform has largely been eliminated by:

- Historically low interest rates; and
- The increased number of Australia's Double Tax Agreements that provide an interest withholding tax exemption for financial institutions.

Support

A key driver of enhancing the attractiveness of Australia as a place to do business, particularly with respect to financial services business, is removing frictions that inhibit the free-flow of capital both in and out of Australia. One such friction is the imposition of interest withholding tax on interest paid by Australian entities (including branches) to offshore lenders and the related tax compliance costs. The removal of interest withholding tax for financial institutions was a key recommendation of the 2009 Johnson Report into Australia as a Financial Centre, and had apparent bipartisan support, but the reform has not been implemented.

The objective of the Johnson Report's recommendation was, broadly, to ensure that Australia has access to a broad range of offshore savings pools to finance domestic investment needs and improve Australia's competitiveness as a financial centre as, for example, it would facilitate bank regional treasury functions. The Report noted that Australia's interest withholding tax regime is inconsistent with the approach taken in other financial centres, as it had the effects of both raising the cost of capital for Australian business (through requiring the payer to "gross-up" for the amount withheld) and also increasing complexity, given the exemptions that exist for payments made to unrelated financial institutions in many Double Tax Agreements and also under Section 128F. It noted 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."

This comment has been echoed by:

- **Senate Standing Committee on Economics 2011 Report into Competition within the Australian Banking Sector:** "The Committee recommends that interest withholding tax be abolished as budgetary circumstances permit to increase the ability of foreign banks to compete in the Australian market."
- **Henry Tax Review: "**Financial institutions operating in Australia should generally not be subject to Australian interest withholding tax on interest paid to non-residents."
- **Financial System Inquiry:** "For 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."

AFMA notes that given globally low (and potentially negative) interest rates at present and the increasing number of Double Tax Agreements that offer an exemption from interest withholding tax for interest paid to unrelated financial institutions, the revenue cost of reform in this area is low. However, the existence of the withholding tax obligation, coupled with the compliance burden associated with determining the circumstances in which interest withholding tax applies, the applicability of any exemptions and the appropriate rate at which to withhold are significant disincentives to establishing regional headquarters in Australia.

As such, AFMA recommends that the Government announce in the 2020/21 Federal Budget a commitment to the Johnson Report recommendation as it applies to interest withholding tax, namely:

- 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; and
- Remove withholding tax on financial institutions' related party borrowing.

A2 - Offshore Banking Unit - Allowing Australia to Capitalise on its Advantages

Recommendation:

The Government should confirm it will retain the OBU regime in an effective form or otherwise ensure that there are appropriate tax settings to provide a tax competitive outcome for international financial centre business that would ordinarily be based in Australia due to non-tax factors.

Support

Australia has significant competitive advantages, including access to skilled workforce, a strong legal system underpinned by the rule of law and relative economic and political stability. In relation to mobile financial services, for which there is significant competition in the region and globally, Australia has appropriately recognised the necessity of tax settings that avoid undermining our natural advantages and allow for business to be conducted from Australia. The mechanism to achieve this is the OBU regime, as extended to cover non-banking activities. This regime enables the Government to support economic activity and optimise revenue from the sector.

The Johnson Report into Australia as a Financial Centre observed that “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.” It does so by applying a tax rate to offshore financial transactions, including funds management activities and trading activities in offshore markets, that is more closely aligned to, but not preferable to, the corresponding tax rate applicable to such activities in key competitor regions in the Asia-Pacific region.

In 2018, the OECD Forum on Harmful Tax Practices commenced a review into the OBU Regime and expressed some concerns regarding the regime, resulting in a commitment from the Government that the regime be amended.

The framework through which the OECD assessed the OBU regime is highly contentious from an Australian industry perspective, particularly as OECD gave the more attractive tax incentives regime in Singapore a clean bill of health. Of particular concern is OECD’s focus on the differential between the OBU tax rate and our headline corporate tax rate, which does not take account of Australia’s dividend imputation system and, of itself, should be irrelevant in assessing if a regime inappropriately distorts the jurisdictional location of mobile financial services business. Moreover, OECD has given no clear guidance on the changes to the OBU regime that would ameliorate its concerns.

It would make more sense for the OECD to consider the OBU regime in the context of its work to introduce a “minimum rate of tax” for international enterprises on all income streams as part of Pillar 2 of the approach to address the digitalisation of the economy. When concluded, this pioneering work will establish clear parameters regarding a jurisdiction’s sovereign right to implement tax settings that are acceptable from an OECD perspective. AFMA believes OECD’s work on digitalisation of the economy and, indeed, to address COVID-19 pandemic issues, have appropriately superseded the work program of the Forum on Harmful Tax Practices.

Having regard to the above, and the urgent need to support economic and employment opportunities in Australia, AFMA asks the Government to commit to a competitive tax regime for international financial centre business by acting on our recommendation.

A3 - Abolition of the LIBOR Cap

Recommendation

The Government should announce the immediate abolition of the LIBOR Cap in the 2020/21 Budget. This would encourage foreign banks to conduct more business in Australia and help provide the critical mass and diversity of business that would help sustain financial services exports. The issue will come to a head when LIBOR itself ceases in 2021, consequent to changes brought about by the authorities in the United Kingdom and the USA.

Support

The LIBOR Cap is a uniquely Australian restriction that limits the tax deductibility of interest expense on internal funding by foreign bank branches. It harms competition, increases intermediation costs and amplifies a perception that Australia is an exceptional and complex tax jurisdiction. Abolition of the LIBOR Cap was considered a 'low hanging fruit' in the 2009 Johnson Report but it remains an outstanding flaw in the Australian taxation system.

The Government asked the Board of Taxation to review the appropriateness of the LIBOR Cap as part of its review into the Tax Arrangements Applying to Permanent Establishments. The Board of Taxation made only one recommendation in its report to the Government, namely:

> "subject to confirmation that the removal of the LIBOR Cap would result in no material cost to revenue, the cap should be removed. That would assist in fostering competition in the domestic market."

In providing context to the recommendation, the Report stated:

> "The 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."

Such comments are consistent with those included in the Johnson Report, which made the recommendation to "remove the LIBOR Cap on deductibility of interest paid on branch-parent funding."

At the Government's request, AFMA has previously provided both the Government and Treasury with revenue estimates of the cost of the removal of the LIBOR Cap, based on survey responses from its members. The cost of removing of the cap was immaterial to tax revenue and removal would deliver significant deregulation benefits, in addition to enhancing banking competition and the provision of product and service innovation by foreign bank branches.

A4 - Corporate Tax Competitiveness

Recommendation

To meet the twin objectives of supporting Australia's economic recovery from COVID-19 and enhancing Australia's competitiveness as a financial centre, the Government should:

- Reduce Australia's corporate tax rate, with an explicit aspiration that it should be no higher than the OECD average; and
- Commit to implement global taxation initiatives in a co-ordinated manner and mitigate differences to the related administrative approach in other jurisdictions.

Support

Corporate Tax Rate

Australia is heavily reliant on corporate income tax, which in 2017 represented 18.5% of total tax collected against an OECD average of 9.3%. Australia's statutory corporate tax rate of 30.0% is the equal third highest in the OECD, the OECD average corporate tax rate in 2017 was 23.2% and the average for Asian jurisdictions was 17.0%. The burden of Australia's high company tax rate falls particularly hard on international investors, as they do not directly receive the benefit of franking credits to alleviate potential double taxation.

Australia's high corporate tax rate hinders its ability to attract capital investment and is a drag on its competitiveness as a financial centre. A reduced corporate tax rate would lead to greater investment in Australia and contribute to improved productivity and higher wages. As such, the Government should re-prioritise its previous commitment to reducing the company tax rate and, in AFMA's view, aspire to a headline company tax rate of no higher than the OECD average.

Taxation Administration

The complexity of Australia's business tax system leads to a perception that it is a difficult jurisdiction to do business in, which is harmful to our competitiveness. There is an increasing number of instances where Australia acts out-of-step with global peers or globally co-ordinated initiatives, such as the OECD BEPS Action Plan. This places pressure on Australia's network of Double Tax Agreements and, thus, heightens the risk of double taxation.

By way of example:

- Australia's implementation of the Multinational Anti-Avoidance Law in 2016 was in advance of the OECD measures to combat the artificial avoidance of crystallising a taxable presence under Action 7 of the BEPS Action Plan;
- The 2017 Diverted Profits Tax was designed to mirror the UK version but failed to account for significant differences in the respective tax systems and, hence, is not fit-for-purpose;
- The exceptional penalties applicable to Significant Global Entities (e.g. fines of up to $525,000 for minor compliance breaches, including some that may not relate to the taxpayer's own tax affairs), are more draconian than penalties in other jurisdictions;
- The overtly technical interpretation by the ATO of how Australia's Debt Equity Rules apply to foreign bank branches calls into question the deductibility of branch interest and discourages such banks from issuing debt in Australia; and
- The administration of multilateral measures is sometimes done in a different manner to other jurisdictions (OECD Anti-Hybrid rules being an example), which prevents multinational companies using a global program to reduce compliance costs.

A5 - Regulation Cost Recovery

Recommendation

The Government should:

- Allocate government funds to cover a part of the cost of running ASIC, AUSTRAC and APRA to reflect the public benefit from this regulation, which would reduce moral hazard and allocate cost recovery charges in a more proportionate and fair manner[4];
- Remove the Enforcement Special Account from ASIC's industry funding model, as a means to give equitable outcomes that are more consistent with the model's principles; and
- Centralise the administration of the funding models for ASIC, AUSTRAC and APRA to improve consistency, efficiency and fairness of the cost burden on regulated entities.

Support

Regulated entities are levied to cover the operating costs of ASIC, APRA and AUSTRAC (whose 'industry contribution' levy is outside the Government's Cost Recovery Guidelines but is clearly cost recovery). The levies operate like a tax and are economically inefficient. They have increased markedly in recent years and can be especially burdensome for new entrants and firms operating on tight margins, making Australia less competitive as a business location.

In 2019-20, the industry levies for APRA and AUSTRAC are expected to be $236m and $79m respectively. The ASIC industry funding model is expected to be $324 million, charged to both financial and non-financial businesses. This represents a direct cost burden of over $639m on Australian business. The Major Bank Levy, budgeted at $1,610m, is in addition to this.

Moral hazard is a significant problem in the design of cost recovery arrangements. The structures for these arrangements present little incentive for government to keep costs low or efficient, as these costs are passed onto the invoiced entities. Moreover, governments have paid little attention to the cumulative burden of *ad hoc* increases in cost recovery levies and also have failed to recognise that the primary beneficiary of regulation is the public, whose interests can in effect only be reflected in a government contribution to regulator funding.

Cost recovery for ASIC's Enforcement Special Account (ESA) is unfair, as it charges the cost of an enforcement action against a particular person to all of the regulated entities in the relevant segment of the industry. Moreover, industry should not be charged for the recovery of enforcement costs where ASIC is unsuccessful in an action, or when where ASIC already receives monies from entities involved in an enforcement action to cover the cost of its related investigation and action.

More generally, the mapping of regulator costs to the regulated community is imperfect and creates distortions and inequity, particularly where the cost burden is poorly calibrated to regulatory risk.[5] The funding models for ASIC, AUSTRAC and APRA sit under different portfolios and adopt unique metrics to determine the population of leviable entities and the amounts payable. There is no central oversight of the different funding models, nor is a consistent rationale or set of principles applied. Moreover, each is administered differently, such that the overall burden on entities is not transparent.

---

[4] Part government funding of the New Zealand's Financial Markets Authority in this regard is an example.

[5] For example, only 570 out of 14,000 reporting entities contribute to the AUSTRAC levy, while AUSTRAC regulation gives rise essentially to a public benefit; such as through crime detection and prevention, and higher tax receipts.

A6 – Positioning Financial System Regulation to Better Support the Economy

Financial Regulation Policy

The financial sector operates best for the economy when government policy is both made and implemented in a manner producing the targeted outcomes in a cost-effective and efficient way. Regulation that effectively addresses a market failure without creating an undue regulatory burden for industry participants contributes to economic productivity, employment and income. On the other hand, regulation that is badly designed or poorly targeted in this regard introduces unnecessary costs and constraints on financial activities and harms the economy.

Notwithstanding periodic attempts to stem the rise of regulatory 'red tape', material shortcomings in the process to make policy decisions and have them implemented by financial regulators emerge too often. The process needs change to better align with the Government's economic growth objective. Table 1 sets out the essence of the issue.

Table 1 - Financial Regulation Process - Issues and Solutions

Policy Stages	Process Actions	Areas for Improvement	Solution
Policy Formulation	*Identify potential need for regulation (Issues paper);* *Test its validity (consultation);* *Assess response options:* *Complete cost/benefit analysis (Regulatory Impact Statement)*	* Preemptive issue verification; * Overreliance on regulators for policy analysis; * Deficient consultation; * Market based solutions under-used; * Inadequate RIS analysis.	* Require full range of policy options to be considered; * Reinstitute CAMAC to assist in complex policy analysis; * Require effective consultation; * Require independent, and tested, RIS.
Policy Determination	*Decision to adopt new regulation is made by a person that is unconflicted using objective, well-informed advice.*	* Decisions may pre-empt completion of full policy analysis; * 'Whole of government' policy outcomes not always achieved; * Industry view is underweighted; * Regulators in effect often make significant policy decisions; * Regulator self-interest too influential.	* Government to require a clear case for regulation before acting; * Minister to makes all significant policy decisions; * Decisions are based on complete and objective policy analysis; * Community net benefit is the litmus test for new regulation.
Policy Implementation	*Regulators operate to the highest professional standard:* *- Balance multiple and competing policy and internal objectives;* *- Provide thorough regulatory guidance;* *- Administer the law efficiently:* *- Investigate objectively and enforce as a model litigator.*	* Regulators should accord a higher priority to supporting the economy, when balancing competing objectives; * Insufficient regulator guidance on market practice and expectations; * Regulators do not always meet the highest standard of operation; * In enforcing the law, regulators face pressure to take and win court cases; * No efficient means to test reasonably held differences about the application of the law.	* Strengthen the govt. Statement of Expectations (SOE) priority to support economic growth; * Regulators separate internal policy, investigation and enforcement roles. * Establish an effective Financial Regulator Assessment Authority (FRAA) and direct it to: - assess regulator performance against new SOEs; - oversee and support high professional standards by regulators; * Introduce a test case scheme.

Regulation is a highly integrated process that involves multiple bodies, including government, the bureaucracy and regulators.[6] While problems may occur independently at any stage in the process, reform to make it work better should take account of the institutional interactions within the policy making and regulatory administration process.

AFMA has devised a set of practical recommendations to improve the regulation process through the policy making and administration cycle. Our recommendations take the lessons from official reviews of the process over the years and advance this by blending in more recent

[6] For example, ambiguous or flawed designed policy usually creates downstream problems in the administration of the law.

experiences, including the effects of secondary factors. For example, the advent of social media as a significant influence requires a strong institutional framework and the application of discipline in decision making to ensure good policy principles are applied in practice.

AFMA's Recommendations on Policy and Regulation

Our recommendations would strengthen, but not replace, the existing and planned institutional arrangements and procedures for policy and regulation. They are based on accepted principles and existing procedures (e.g. Statements of Expectations, Regulatory Impact Statements) and government proposals (i.e. a Financial Regulator Assessment Authority). The measures would require Budget funding, but only a small amount annually which can be sourced by redirecting some current (and planned) expenditure. However, they would require political leadership and commitment to their implementation to be effective.

Table 2 – AFMA Recommendations

AFMA Recommendation
1. Regulatory Policy Principles The Government should commit to the 6 principles in the Taskforce on Reducing Regulatory Burden on Business (TRRB) and institute a process to ensure they are adopted by ministers and their agencies. See Taskforce on Reducing Regulatory Burdens on Business (2006)
2. Policy Issue Identification and Consultation TRRB principle 2 applies - "*A range of feasible policy options (including self-regulatory and co-regulatory approaches) need to be identified*." TRRB principle 6 applies -"*There needs to be effective consultation with regulated parties at all stages of the regulatory cycle*". Consultation should be genuine, with no pre-determined outcomes. The Government should: (a) Establish a specialist body with a fulltime secretariat and an expert advisory board to take complex policy matters offline for examination in a thorough and objective manner (similar to the previous Corporations and Markets Advisory Committee[7] or the role of the Board of Taxation[8]).
3. Regulatory Impact Statement (RIS) Process: TRRB principle 2 applies – "*... benefits and costs, including compliance costs, assessed within an appropriate framework.*" The Government should: (a) Require the RIS to be prepared by an unconflicted person (e.g. the RIS for an ASIC legislative instrument should prepared by Treasury or an independent expert selected by Treasury); (b) Require the RIS author to consult with recognised stakeholders on a draft version of the RIS; and (c) Require the RIS author to objectively test the reasoning, views and information provided by recognised stakeholders (including market participants and regulators).
4. Policy Decision making: TRRB principle 1 applies – "*Governments should not act to address 'problems' until a case for action has been clearly established ... recognising not all 'problems' will justify (additional) government action*". TRRB principle 3 applies – "*Only the option that generates the greatest net benefit for the community, taking into account all the impacts, should be adopted*". TRRB principle 4 applies – "*Effective guidance should be provided to relevant regulators ...... in order to ensure that the policy intent of the regulation is clear, as well as the expected compliance requirements.*" The relevant Minister should:

[7] http://www.camac.gov.au/camac/camac.nsf/0/3ca03f6a542a65e1ca256e7800092e89.html
[8] The Board of Taxation's mission is to contribute a business and broader community perspective to improving the design of taxation laws and their operation.

	(a) Make all significant policy decisions and the Government should review existing delegations to regulators to ensure this; and (b) Give equal consideration to the arguments and reasoning of recognised stakeholders (including market participants and regulators) when making a policy determination.
6.	**Statements of Expectations (SOE)** The Government should revise SOEs to: (a) Provide clear guidance to regulators on its priority to support economic growth and international competitiveness; (b) Require regulators to provide guidance on the law and rules they administer that is comprehensive, up to date and presented in a user-friendly manner; (c) Require regulators to administer the law in a manner that appropriately distinguishes between retail clients and more sophisticated wholesale clients; and (d) Require objective analysis by the regulator of a global standard before it is adopted in the Australian market context.
6.	**Regulatory Guidance** (a) Whether as a response to a new SOE, or as a matter of good regulatory practice, regulators should provide clear, readily accessible and up to date guides for the firms they regulate in respect of: − the law and regulation they administer; − their approach to administering the law (including their interpretation of key provisions); − the associated regulatory rules that must be followed; and − their expectations of relevant licensees and authorised entities; with the objective providing a clear, consistent and predictable (no surprises) framework for regulated entities to plan and manage their business operations. (b) The Government should introduce a 'Test Case Scheme' for ASIC that is based on the same principles as ATO's test case scheme and that operates in accord with ASIC's organisational structures.
7.	**Financial Regulator Assessment Authority (FRAA)** The Government should establish its proposed FRAA and (a) provide it with the necessary resources (including senior personnel) and scope of operation to enable it to function effectively. (b) Direct FRAA to review and report on regulators in regard to: − Conformance with the Government's SOE for the regulator; − Exercise of their powers, including making legislative instruments; − Priority to support for economic growth, international competitiveness and financial system development, when exercising their powers; − Management of competing objectives and related conflicts of interest; and − The professional standards maintained by a regulator, including policies and procedures governing licensing and enforcement, and their adoption.

Finally, we note that government has multiple policy objectives, which at times conflict with each other and must be balanced in accordance with its priorities. In relation to financial services, Treasury is the policy body with comprehensive coverage of national priorities. It is important that Treasury is resourced to operate independently of the regulators who are major stakeholders in the policy process. Treasury must retain an intellectually strong and well-resourced policy-making capability that can take a strategic top down, objective approach to financial system oversight and law reform.