1990-91-92

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAXATION LAWS AMENDMENT BILL (NO. 4) 1992

SUPPLEMENTARY EXPLANATORY MEMORANDUM

(Circulated by authority of the Treasurer, the Hon. John Dawkins, M.P.)

36083/92 Cat. No. 92 5157 9

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Printed by Authority by the Commonwealth Government Printer

Division 9A - Offshore Banking Units

General Outline and Financial Impact

The amendments will clarify certain aspects bearing on the scope of the OBU measures and make it consistent with business practice.

They also tighten certain aspects of the anti-avoidance provisions and correct some minor technical deficiencies;

The scope of the activities has been widened to include transactions which are of the same type as those originally included in the Bill;

The interest withholding tax exemption for OBUs has been extended to allow the funds to all offshore borrowings for use in offshore banking activities. (The previous exemption was limited to offshore borrowings for the purpose of on-lending); and

Wholly owned bank subsidiaries are to be allowed to be registered as OBUs.

Revenue impact: None

Explanation of the proposed changes

The amendments and new clauses will make the following changes to the Bill. The reference to "Amendment numbers" at the end of each topic discussion correspond to the numbers in brackets in the margin of the amending legislation and are used to assist cross-referencing.

Object and simplified outline

To assist readers in using the legislation, a proposed new subdivision AA is to be inserted, which sets out in simple terms the object of the Division, the main concepts of the concessional tax regime and how the provisions fit together ***[Amendment 1].***

Borrowing and lending activities

Proposed section 121B sets out what activities, including borrowing and lending, can constitute OB activities, the income from which is taxable at the concessional rate.

The normal meaning to the terms "borrow" and "lend" are to be expanded to include the issue and purchase of securities because it has become commonplace for commercial finance to be obtained or provided in this way. Thirty, sixty and ninety day bank bills issued at a discount are examples of this type of fund raising ***[Amendments 2 and 4].***

Eligible contract activity

The definition of the term "eligible contract" in proposed section 121A is to be expanded to include an options contract, a cap, a collar, floor or similar contract.

A technical correction to proposed subsection 121B(1) and the insertion of proposed new subsection 121B(4A) are also necessary to ensure that transactions that only require an exchange of contracts and that are not actually traded (such as a currency or interest rate swap) are specifically included in the range of OB trading activities that can qualify for concessional tax treatment ***[Amendments 3, 9 and 14].***

Non-OB money

The meaning of the term "non-OB money" in proposed section 121A is to be changed. One of the threads running through the offshore banking legislation is that "non-OB money" cannot generate concessionally taxed income. Broadly, "non-OB money" comprises domestic funding and funding (including income) generated in dealings outside the scope of concessionally taxed activities (eg profits from Australian dollar transactions with residents where the transactions are not connected with overseas branches of those residents).

The definition proceeds by way of including all money of the OBU and then making specific exclusions. The term is used in determining the amount of "assessable OB income" (proposed section 121EC) and in the test in proposed section 121EF designed to ensure that the concessional tax rate is available only where the transactions as a whole are predominately of an offshore banking kind.

Two changes are made. First, a consequential change is made to reflect the change from "OBU owner money" to "OBU resident-owner money". This is explained in the section headed "OBU resident-owner money".

Secondly, the provision of funds by non-resident owners does not present the same potential problems of tax rate arbitrage and domestic sourcing as money provided by resident owners, especially where the funds are injected by way of paid up capital. Since the subscription for shares does not fall within any of the categories of OB activity, a specific provision is needed in the definition of "non-OB money" to ensure that the use of such paid up capital

provided by a non-resident from offshore sources can generate concessionally taxed income ***[Amendment 5]***.

OBU resident-owner money

This term was previously called "OBU owner money" and was expressly excluded from the category of "non-OB money". This meant that "OBU owner money" could have been used to produce concessionally taxed income if used in offshore banking activities.

In broad terms, the Bill currently provides in proposed section 121EI that where "OBU owner money" is made available to an OBU, 90% of the money provided is to be regarded as a loan. Notional interest is then included in the assessable income of the owner to offset the likelihood that the owner would have obtained tax deductions for interest expense on most of the money provided to the OBU.

In terms of proposed section 121EA as introduced, "OBU owner money" means money made available for use in OB activities of the OBU by the owner of the OBU, whether by way of a loan, gift, share subscription or otherwise, where the money was borrowed by the owner and any interest payable by the owner of the money is an allowable deduction from the assessable income of the owner.

The definition of "OBU owner money" presents two problems. First, it requires a matching of the source and application of particular funds. This would present difficulties since money is fungible. Accordingly, it would be hard to apply the anti-avoidance provision in proposed section 121 EI (referred to above).

The revised provision will not require funds to be traced but will assume 90% of any funds provided have come from borrowings for which tax deductions for interest expense are available. Since this will be the case only where the provider of funds to the OBU is a resident the definition has been limited accordingly.

Secondly, if resident owners could fund OBUs by providing loans or gifts there would be a risk that domestic funds could be used. This would be inconsistent with the intention to limit the concession to "pure" offshore banking funded from overseas sources.

Accordingly, it is proposed to change the definition of "OBU owner money" to "OBU ***resident-owner*** money" in proposed section 121EA and to confine it to share subscriptions. Since redeemable preference shares have many of the characteristics of loans they have been excluded. Share premiums have also been excluded in order to limit tax avoidance opportunities.

Any moneys other than acceptable share subscriptions made available by a resident parent company will now constitute "non-OB money", the income from which is taxable at the normal rate of 39%. Any such "tainted" income will also be taken into account in applying the 10% "purity" test in proposed section 121EF ***[Amendments 6, 23 and 30].***

Related person

Borrowing and certain other concessional activity by an OBU is restricted to non-Australian currency if the transaction is with a related party. This is to protect leakage from existing domestic banking business, limit access to domestic funding and to prevent OBUs getting around the general prohibition against dealing with residents.

The Bill presently effectively defines a related person in section 121A as an owner or branch of the OBU. As it would be possible for an OBU to deal with another subsidiary of the owner and thus avoid the restriction prohibiting dealing in Australian currency the term "associate" is being substituted (which has a much wider application) for the term "owner" ***[Amendment 7].***

Meaning of the term "security"

The meaning of a security as defined in proposed section 121A is to be expanded to make it clear that the term includes a bill of exchange or a promissory note. Trading with an offshore person in securities issued by non-residents is an OB activity in terms of proposed subsection 121B(4) (the income from which is taxed concessionally), provided the securities are denominated other than in Australian currency ***[Amendment 8].***

Guarantee-type activity

The Bill, as introduced, provided for the concessional tax regime to apply to fee income of OBUs for guarantee-type activities such as underwriting a risk for an offshore person. To minimise any possible revenue leakage, proposed subsection 121B(3) is to be amended so that the concession will only apply to underwriting a risk with an offshore person where the property is outside Australia or the event being underwritten can only happen outside Australia ***[Amendment 10].***

Sydney Futures Exchange

Proposed subsection 121B(4) extends the concessional tax regime to various trading activities by an OBU on its own behalf. This amendment will allow an OBU to trade in futures with the Sydney Futures Exchange on its own behalf as well as on behalf of an offshore person, thus expanding the range of OB activities that will qualify for concessional tax treatment. However, any money payable under the contract may not be in Australian currency ***[Amendment 11].***

Trading in currency

A technical amendment is to be made to clarify the operation of proposed paragraph 121B(4)(e) - the provision that deals with currency trading. The amendment will ensure that trading in options or rights in respect of currency as well as actual spot or forward currency trading can qualify for concessional tax treatment *[Amendment 12].*

Trading in bullion

Proposed paragraph 121B(4)(f) is to be amended to allow trading with an offshore person in silver and platinum bullion as well as gold bullion. The amendment will also expand the scope of the provision by including trading in options or rights in respect of such bullion. It also imposes a general restriction that any money payable or receivable is not to be Australian currency. This recognizes the status of precious metals as quasi currency and brings the treatment of such transactions into line with the prohibition on Australian dollar transactions applying to foreign exchange dealings *[Amendment 13].*

Investment activity (Funds Management)

Proposed subsection 121B(5) is to be amended to make it clear that an OBU is acting in the capacity of a broker, agent or trustee in making or managing an investment for the benefit of an offshore person and not on its own behalf *[Amendments 15 and 16].*

Advisory activity

The scope of proposed subsection 121B(6) is to be extended so that it applies to financial advice generally and is not limited by reference to certain types of transactions. The advice is not to be restricted as long as it does not involve any property or transactions in Australia. It may, for example, take the form of advice on financial structures, corporate strategic planning, defending takeovers etc. as well as relevant investments.

The amendment to proposed subsection 121B(6) will also make it clear that advice may involve an investment in Australia as long as it is incidental (such as profit comparisons) to advising on an investment outside Australia ***[Amendment 17].***

Hedging activities

To avoid confusion as to what constitutes trading activities in terms of proposed subsection 121B(4) and what constitutes hedging activities in terms of proposed subsection 121B(7) amendments to proposed subsection 121B(7) will have the effect of limiting hedging to interest rate and currency exposures in respect of borrowing and lending activities ***[Amendments 18 and 19].***

Proposed new subsection 121B(8) will ensure that the previous amendments will not limit the scope of any other OB activity as any other activities will constitute trading activity in terms of proposed subsection 121B(4). For example, a hedge of a foreign currency trading book will be regarded as just another trade. In fact there will be greater flexibility in hedging a loan because a currency exposure transaction can be a trade if the OBU wants to deal with a resident in non-Australian currency or a hedge if it wants to deal in Australian currency with an unrelated offshore person ***[Amendment 20].***

The amendments also reflect the commercial reality that foreign exchange trades and hedges are not separated in the trading books and, in a sense, accords with the intrinsic nature of a hedging of a trading book. In substance, therefore, the changes produce a manageable situation for OBUs since limiting the hedging activity to loans results in the same restrictions applying to hedges as apply to the underlying transaction being hedged. The amendments also mean consistency is achieved in relation to foreign exchange trading and the hedging of the trading books.

Meaning of "offshore person"

Since it is the enterprise as a whole rather than a particular branch that is gazetted as an OBU, financial institutions need to know when they deal with each other whether they are dealing in the capacity of OBUs. This is especially important in the classification of funding obtained through such transactions because "tainted funds" cannot produce concessionally taxed income.

Amendments to proposed subsection 121C will ensure that an OBU that deals with another OBU knows whether or not the loan money is able to generate income which will be subject to the concessional tax rate. Where an OBU lends OB money to another OBU it will be required to give a statement to the second OBU to the effect that the money is not "non-OB money". (Non-OB money is discussed above.) This will also enable the OBU to correctly identify whether the particular activity is an OB activity and record details of the transaction in the correct books of account ***[Amendments 21 and 22].***

Assessable OB income

The meaning of the term "assessable OB income" in proposed subsection 121EC(2) is to be changed to ensure the use of "non-OB money" cannot give rise to concessionally taxed income. This change corrects a technical deficiency in the definition in the Bill as introduced, which would have otherwise permitted an OBU to obtain concessional tax treatment for some assessable income derived from the use of "non-OB money" in OB activities. It should be noted in this regard that proposed section 121EF results in the loss of all concessional tax treatment where more than 10% of the assessable income from offshore banking activities comes from the use of "non-OB money". The change to the definition of "assessable OB income" will mean that where even $1 of assessable income is derived from the use of "non-OB money" that $1 will be taxed at the normal rate of 39%, and the whole of the assessable income will be taxed at 39% if the 10% "purity test" threshold in proposed section 121EF is exceeded ***[Amendment 24].***

"Adjusted assessable OB income" and "Adjusted total assessable income"

Both of these terms are used in determining the amount of *general OB deductions*, which together with *exclusive OB deductions* and *apportionable OB deductions* reduce the *assessable OB income*. Amendments to proposed subsections 121E(3) and (4) make technical corrections to ensure that only interest exclusively incurred in deriving relevant income is taken into account.

The amendments also make it clear that the term "interest" includes a discount in the nature of interest. This will result in a fairer allocation of expenses given that a significant amount of commercial borrowing and lending is done through the issue and purchase of discounted bills of exchange ***[Amendments 25 and 26].***

Definitions relating to allowable deductions of an OBU

A minor drafting error is corrected by substituting the word "section" for the word "Division" in proposed subsection 121ED(1) - a provision which sets out the purpose of section 121ED ***[Amendment 27].***

Remaining amounts not exempt income

The Bill provides for the taxation of the profits of the OBU from qualifying transactions at an effective rate of tax of 10%. Rather than providing a special tax rate for this purpose, the assessable income and allowable deductions are adjusted downwards to 10/39ths to achieve the same result.

Concern has been expressed that the 29/39 fraction not included in the assessable income could be considered to be exempt income and any prior year losses would, therefore, have to be reduced by the remaining 29/39 amount before being offset against assessable income.

To make it clear that the remaining amounts are not exempt income in the conventional sense and should not reduce prior year loss deductions, the Bill is to be amended by inserting proposed subsection 121EE(2A) ***[Amendment 28].***

Loss of special treatment where excessive use of non-OB money

Proposed section 121EF is being changed as a consequence of the amendment to paragraph 121EC(2)(b), the definition of "assessable OB income". (See the above discussion of this topic in relation to Amendment 24).

The amendment will result in the adding back of the "tainted income" for the purposes of the 10% "purity test" so that the test will now be based on all the income in the OBU's separate accounts, not just the income otherwise entitled to the tax concession ***[Amendment 29].***

Deduction for deemed interest

Where share capital is made available to an OBU by its parent, 90% of the funds are regarded as a loan and notional interest is included in the assessable income of the parent and taxed at 39% (see notes on OBU resident-owner money). This is primarily a tax avoidance provision aimed at preventing a parent from obtaining an interest deduction at the 39% tax rate, injecting funds into the OBU by way of equity thus allowing the OBU to derive income taxable at 10%.

Proposed subsection 121EI(3) will permit the OBU to claim an income tax deduction for the deemed interest. Because an OBU will be taxed at an effective tax rate of 10%, the deduction will also have a tax effect of 10% ***[Amendment 31].***

Exemption of income of OBU offshore investment trusts

Income from fees from funds management is included in the range of OB activities that will qualify for concessional tax treatment as long as the investors are non-residents and the investments are not in Australian currency (proposed subsection 121B(5)).

Proposed section 121EJ will ensure that the income and capital gains derived through the investment activities of the OBU on behalf of non-residents are exempt from Australian income tax. The effect will be that only the fee income generated by the management activities of the OBU will be subject to Australian tax ***[Amendment 32].***

Because of the operation of subclause 18(5A), the exemption will apply from 1 July 1992, the proposed start date for the new OBU regime ***[Amendment 40].***

Extension of the Interest Withholding Tax (IWT) exemption

The law presently provides an exemption from withholding tax for an OBU where the funds are on-lent to a non-resident. A series of amendments to section 128AE of the Assessment Act will have the effect of extending the exemption to offshore borrowings used to fund the extended OB activities. This means, for example, that if an OBU borrowed funds from a non-resident and used those funds for trading in accordance with the requirements of proposed subsection 121B(4) it would be entitled to an exemption from IWT in respect of the borrowings ***[Amendments 33, 34 and 38].***

Registration of a subsidiary of a bank as an OBU

Under the present law the only entities that can be registered as OBUs are savings and trading banks as defined by subsection 5(1) of the *Banking Act 1959*, State banks and other financial institutions which the Treasurer is satisfied are appropriately authorised to deal in foreign exchange (in effect this means approved as foreign exchange dealers by the Reserve Bank of Australia).

Amendments to subsection 128AE(2) and (2B) of the Assessment Act will extend the range of entities which can be registered as an OBU to include a wholly owned subsidiary of a bank which is already registered as an OBU. Because of the operation of section 23 of the *Acts Interpretation Act 1901* sub-subsidiaries will also be able to be registered as OBUs as long as all the shares are beneficially owned by an OBU which is a bank ***[Amendments 34 and 36].***

Loss of Registration of Parent OBU

The Bill, as introduced, empowers the Treasurer to declare by notice published in the Gazette that a person is no longer an OBU because of some serious default.

Where an OBU, which has been registered under new paragraph 128AE(2)(ba) solely because it is a wholly owned subsidiary of a bank which is already an OBU, loses its registration because of serious default, the parent OBU which wholly owns the subsidiary will also lose its registration. The loss of registration will extend to any wholly owned subsidiaries interposed between the parent and the subsidiary.

If this provision was not present, the subsidiary that lost its registration because of serious default could simply transfer its OBU business to its parent.

Because of the operation of proposed paragraph 128AE(2)(ba) if the parent lost its OBU registration any subsidiaries that were registered OBUs solely because they were subsidiaries would automatically lose their registration ***[Amendment 35].***

Continuation of OBU status

Proposed subsection 128AE(2C) ensures that an OBU continues to enjoy OBU status provided it does not lose its banking or foreign exchange dealers licence and provided it is not declared by the Treasurer to no longer be an OBU because of serious default.

An amendment of proposed subsection 128AE(2C) will ensure that a subsidiary of a bank that attains OBU status by reason of its relationship with its parent will also continue to enjoy similar OBU status subject to similar conditions ***[Amendment 37].***

Special tax payable in respect of certain dealings by current and former offshore banking units

Subsection 128NB(1) of the Assessment Act provides that a special income tax imposed by the *Income Tax (Offshore Banking Units) (Withholding Tax Recoupment) Act 1988* is payable by a person who is or has been an OBU on the "lost withholding tax amount" in respect of certain transfers of money.

As a consequence of extending the exemption from IWT to OB activities other than offshore lending (see notes on amendments 33, 34 and 38), subsection 128NB(1) is also being amended to extend its operation to all OB activities ***[Amendment 39].***

Transitional - 1 July 1992 to commencement

Some of the amendments proposed could have a possible adverse effect on an OBU. Wherever this could happen a transitional provision will have the effect of applying the rules as set out in the Bill as originally introduced on 24 June 1992 for the period from 1 July 1992 to the date of commencement.

The following provisions will operate as originally introduced for the transitional period;

- the definition of "non-OB money" (proposed section 121A);
- the definition of "related person" (proposed section 121A);

  the amendment to guarantee-type activity (proposed paragraph 121B(3)(b));

the requirement that any money payable or receivable in respect of gold bullion trading is not Australian currency (proposed paragraph 121B(4)(f));

- restricting hedging activities to borrowing and lending activities (proposed paragraphs 121B(7)(a) and (b));
- the requirement for an OBU to make a statement that money paid to another OBU is not non-OB money (proposed paragraph 121C(c));
- the meaning of "OBU owner money" (proposed section 121EA); and
- deemed interest to be based on the original definition of "OBU owner money" (proposed subsection 121EI(1)).

[Amendment 41]