20 February 2013

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Dear Meghan,

Over-the-Counter Derivative Reforms - Australian Interest Withholding Tax

The Australian Bankers Association (ABA), the Australian Financial Markets Association (AFMA) and the Financial Services Council (FSC) welcome the opportunity to provide a submission to Treasury regarding our joint concerns on the potential imposition on Australian interest withholding tax on payments made under centrally cleared OTC derivatives.

In response to the April 2012 Consultation Paper[1] on the implementation of a framework for Australia's G20 over-the-counter ("OTC") derivative commitments, members of both the ABA, AFMA and the FSC noted concerns regarding the potential imposition of Australian withholding tax issues associated with dealing with offshore central counterparties and brokers.

The attached paper (Australian Taxation Issues Paper) seeks to elaborate further on those Australian taxation concerns and highlight to Treasury what, in the view of the ABA, AFMA and the FSC, is an unintended consequence of the implementation of the G20 commitment to OTC derivatives reform.

OTC Clearing - International Context

While G20 member nations (including Australia) are at varying stages of the developing rules to meet their OTC clearing commitments), Australian market participants are increasingly being directed to clear transactions as a result of their involvement in global markets and as a response to Australia's commitment as part of the G20.

The Council of Australian Regulators (RBA, APRA, ASIC and Treasury) have released several consultation papers discussing the path to clearing for Australian entities and strongly encouraging them to move quickly to clearing standardised derivatives. In December 2012, Treasury released a Proposals Paper entitled ""Implementation of Australia's G20 over-the-counter derivatives commitments" that

[1] A discussion paper was originally released by the Council of Financial Regulators in June 2011. This includes a detailed discussion of the background to the OTC reforms. The discussion paper can be found at the following link: http://www.rba.gov.au/publications/consultations/201106-otc-derivatives/pdf/201106-otc-derivatives.pdf

sought stakeholder feedback on the proposed Australian response, with the paper noting that it is incumbent upon the financial services industry to move towards central clearing.

A key element of OTC derivative reform (including the US and European models) is the requirement for cleared derivative positions to be collateralised and cleared through an appropriately structured and regulated central counterparty ("CCP"). This increased collateralisation of OTC cleared trades will result in an increase in daily interest flows between market participants and the CCPs. This trend has become evident already in the Australian interest rate swap market and will become more pervasive as the mandate for Australian participants registered in the US as "swap dealers" to clear becomes effective on 11 March 2013.

The ABA, AFMA and the FSC are concerned that payments of daily interest on collateralised positions by Australian participants will be subject to Australian interest withholding tax - resulting in potentially market distorting outcomes. In short, the collateral requirements in respect of cleared trades will result in payments of interest on collateral amounts by the Australian participants; these payments will attract interest withholding tax when paid to a foreign payee.

In raising these concerns, the ABA, AFMA and the FSC note that industry practice will require that the paying entity bear the cost of any withholding tax. This will be achieved by requiring the paying counterparty to gross up interest payments. Any Australian interest withholding tax will therefore be borne by Australian participants on OTC cleared trades. Economically, this requirement to gross up may be reflected in the pricing of transactions offered by Australian participants.

Implications for Australian Participants

The ABA, AFMA and the FSC are concerned to ensure that Australian participants are not at a competitive disadvantage as a result of the imposition of Australian withholding tax. Many market participants will be located in jurisdictions that either do not impose withholding tax on interest payments, provide specific withholding exemptions in respect of cleared trades or will otherwise not be required to withhold on payments to Australian participants or participants in other jurisdictions.

In the absence of an appropriate Australian interest withholding tax exemption, the ABA, AFMA and the FSC are concerned that the imposition of Australian interest withholding tax:

- may impact negatively on the liquidity of the Australian derivatives market;
- may promote a commercial disincentive to participate in the Australian market with Australian counterparties; and
- may limit Australian participants' access to global markets.

The ABA, AFMA and the FSC estimate that the imposition of Australian interest withholding tax could result in the addition of around 1 basis point to a cleared trade, resulting in a competitive disadvantage for Australian participants (noting that trades can be won or lost on 1 basis point).

The Australian derivatives market is of a significant size and magnitude and generates substantial revenues for Australian based market participants. The ABA, AFMA and the FSC are concerned that the competitive disadvantage of the imposition of Australian interest withholding tax could result in trades that would otherwise be undertaken with an Australian resident entity being undertaken with counterparties in jurisdictions that do not impose withholding tax. Australian resident entities would have to include an option cost in the price to reflect the possible requirement to withhold if market prices moved, a cost that would not be included by non-resident price-makers. It is conservatively estimated that about 20 – 25% of the Australian derivative trades could be lost to offshore locations. The loss of revenue to the Australian Treasury would be significant.

The potentially significant economic impact of such a market distortion (and resultant loss of corporate tax revenue) should be contrasted with the expectation that the interest withholding tax raised on cleared trades will be minimal, albeit sufficient to impact trade pricing. This is because withheld amounts will be calculated on the net Australian position of counterparties and will be contingent on relative interest rates offered.

It should also be borne in mind that any withholding tax imposed on cleared trades should not be included in Treasury revenue forecasts, given that the imposition of the interest withholding tax was not an intended consequence of the implementation of the G20 commitments and the amount of revenue to be derived is unpredictable at best.

With this in mind, it is considered that it would be appropriate to introduce a legislated interest withholding tax exemption for interest flows related to trades cleared in accordance with rules set by a CCP who has been recognised as an approved party by the relevant Australian regulators. For the reasons noted above, the overall impact to the Australian budget would be minimal, but the overall economic impact of doing nothing would be significant.

Withholding Tax: Counter to Transparency

The ABA notes that Australia's G20 commitment to the reform of global financial markets was borne out of a desire for greater transparency and the mitigation of systemic risk.

In this context, implementation of Australia's G20 commitments should not be used as a mechanism to raise revenue which would create a disincentive for Australian residents to move to clearing. This would be counter to the policy of enhancing the stability and competitiveness of the Australian financial system.

In this context, the attached paper contains a description of the Australian interest withholding tax impact of the OTC derivative reforms for Australian counterparties arising from enhanced collateralisation requirements.

It is noted that the attached Australian Taxation Issues Paper analyses the potential imposition of Australian interest withholding tax on payments made by Australian participants to non-resident CCPs. To the extent that an Australian entity/branch becomes an authorised CCP in the future, payments may be made from that CCP in Australia to non-resident participants. It is the view of the ABA, AFMA and the FSC that, for the reasons set out above, such payments should similarly be exempt from interest withholding tax.

Yours sincerely,

Tony Burke David Lynch Martin Codina

Over-the-Counter Derivative Reform

Australian Taxation Issues Paper

February 2013

1. Extraterritorial application for Australian counterparties

Pursuant to Australia's G20 commitments, Australian regulators have been devising a framework for the regulation of Australia's OTC market.

A number of consultation papers and discussion papers have been released and industry consultations undertaken[2] on the development of the Australian framework. This has culminated in the enactment of the Corporations Legislation Amendment (Derivative Transactions) Act 2012 – which creates a legislative framework to impose mandatory reporting, clearing and execution of derivatives transactions so as to satisfy Australia's commitment to the regulation of OTC derivatives, as sought by the G20.

Each of the consultation and discussion papers, numerous submissions (including submissions by the Group and AFMA) have noted that it is imperative that the Australian rules are developed with an understanding of the broader international developments and the potential extraterritorial application of offshore regimes when devising an Australian clearing framework, and the approach taken in the enactment of the legislation referred to above is consistent with this idea.

For example, the March 2012 report by the Council of Financial Regulators noted the highly international nature of the Australian financial services market – both in terms of the role played by foreign banks and the importance that cross-border capital flows have for the Australian financial market, particularly given that Australia is a net importer of capital. Consequently, it is crucial that adherence to the G20 commitments is undertaken in a way that minimises the impediments to the free flowing of capital.

The ABA, AFMA and the FSC are mindful that international developments have resulted in direct extraterritorial impacts on transactions undertaken by Australian participants. In particular, EU Regulation and the US Dodd-Frank Act in the US will impose mandatory clearing and reporting obligations on a broad range of derivatives[3]. This will necessitate Australian participants wishing to enter OTC derivatives with US bank counterparties being required to clear these transactions under the Dodd-Frank rules.

In other words, as Australian participants are heavily reliant on international market participation, Australian participants will effectively be forced to clear OTC derivative transactions pursuant to the US, EU and other regulatory regimes.

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[2] These reviews include:

- Discussion Paper: "Central Clearing of OTC Derivatives in Australia" (June 2011)
  http://www.rba.gov.au/publications/consultations/201106-otc-derivatives/pdf/201106-otc-derivatives.pdf
- Consultation Paper: "*OTC Derivatives Market Reform Considerations* " (March 2012)
  http://www.rba.gov.au/payments-system/clearing-settlement/otc-derivatives/201203-otc-der-mkt-ref-con/pdf/201203-otc-der-mkt-ref-con.pdf
- Consultation Paper: Implementation of a framework for Australia's G20 over-the-counter derivatives commitments (April 2012)
  http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2012/Over%20the%20counter%20derivatives%20commitments%20consultation%20paper/Key%20Documents/PDF/OTC%20Framework%20Implementation_pdf.ashx
- Supplementary Paper: "Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities" (July 2012)
  http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/~/media/Treasury/Consultations%20and%20Reviews/2012/cross%20border%20clearing/key%20documents/pdf/cross-border-provision.ashx

[3] http://www.financialstabilityboard.org/publications/r_120615.pdf

Further, the reliance of the Australian finance market on international markets will require the participation of offshore counterparties in the Australian regime.

This paper notes that the extraterritorial reach of the US, EU and indeed the Australian schemes together with the increased collateral requirements, will result in Australian interest withholding tax implications for Australian participants, which is considered to be an unintended consequence of the adherence to the G20 commitments. As noted in AFMA's submission to Treasury of 15 June 2012, "(t)here should be a government commitment to ensure that other laws, such as tax and insolvency laws, do not have adverse consequences for entities complying with the new regime, which would otherwise impede the systemic stability of the OTC derivatives reforms."

Using the requirements of the Dodd-Frank reforms and the regulations of the US Commodity Futures Trading Commission ("CFTC") as an example, this paper seeks to illustrate how the obligation to clear OTC derivatives traded with US counterparties through a regulated derivative clearing organisation will have a withholding tax impact for Australian participants[4].

In raising these concerns, the ABA, AFMA and the FSC are mindful that the stated policy approach of the Australian regulators is to ensure that any OTC clearing reforms encourage a reduction of systemic risk. The regulators have noted that the key to this will be relative price signals to market participants compared to the relative cost of non-centrally cleared transactions[5].

The ABA, AFMA and the FSC are concerned that the imposition of Australian withholding tax on cleared OTC derivative trades will be counter to this intention – both in terms of the international operation of OTC clearing and the development of any Australian model. Accordingly, it is our submission that, in order to appropriately implement Australia's commitment to OTC derivative reform and to not frustrate the effective operation of similar implementation by other jurisdictions, any interest that is paid to a CCP or a Futures Commission Merchant ("**FCM"**) by virtue of the transaction being centrally cleared be exempt from interest withholding tax.

2. The US Clearing Model

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") introduces a wide range of changes to the financial regulatory framework, including major changes to the rules on capital and systemic risk regulation.

Part VII (Wall Street Transparency and Accountability) of the Dodd-Frank Act deals with the OTC derivative reforms. Broadly, the OTC requirements deal with (amongst other things):

- Registration of swap dealers and major swap participants;
- swap clearing and execution;
- swap reporting; and
- increased collateral requirements for swap transactions.

Entities (including Australian banks) that engage in derivative trading are required to be registered (or will have to register) with the US Commodity and Futures Trading Commission ("CFTC"), the US Securities and Exchange Commission ("SEC"), or both, depending on the relevant derivatives activity engaged in (with derivatives classified as "swaps" being regulated by the CFTC and derivatives classified as "security-based swaps" being regulated by the SEC).

[4] Whilst the Australian withholding tax considerations are likely to be similar under the EU model, this paper has focussed on the US model as this is anticipated to be the dominant model for Australian counterparties.

[5] As outlined in section 6.3 of the March 2012 Consultation Paper.

The Dodd-Frank Act requires certain swaps to be cleared through a Derivatives Clearing Organisation ("DCO") regulated by the CFTC. The DCO's Clearing Members are responsible for clearing derivatives either on their own behalf or for customers.

Whilst the Dodd-Frank reforms clearly apply to US institutions, the US requirement in relation to the clearing of swap trades has a broad extraterritorial reach, impacting, in addition to US institutions:

- US agencies, branches and subsidiaries of non-US financial institutions;
- non-US clearing houses; and
- non-US financial institutions that trade with US entities.

Australian participants are likely to be impacted in various ways, including by virtue of their registration with the CFTC as "swap dealers", which will directly subject such Australian swap dealers to the clearing mandate when trading with US entities.

At least initially, Australian participants generally will not be registered as Clearing Members of any of the DCOs. This will mean that Australian participants will need to clear trades using registered DCO Clearing Members, who will be registered as Futures Commission Merchants ("FCMs"). Australian participants anticipate that they will become DCO Clearing Members in the future. FCMs act as agent and guarantor of the client's margin and other obligations to the clearing house, and face the DCO.

Further, organisations such as the Australian Securities Exchange ("ASX") have announced proposals to develop an OTC interest rate derivatives service, that is, become a DCO. In their announcement dated 20 December 2012, ASX noted that ASX is developing a "new service [that] will provide central counterparty clearing for OTC traded A$ interest rate derivatives".[6]

2.1. Collateral Management

As part of the regulation of clearing transactions, FCMs are required to meet certain collateral requirements relating to "Cleared Swap Customer Collateral".

In January 2012, the CFTC adopted final rules on the "Protection of Cleared Swaps Customer Contracts and Collateral"[7] requiring the segregation of Customer's margin accounts. The approach adopted was to require "legal segregation with operational commingling" ("LSOC").

A general description of the collateral process is contained in the US regulations, as follows:

> *"To secure the prompt payment of variation obligations, the DCO will require each Clearing Member to post collateral (often referred to as ''margin'') for the transactions it clears (separately for customer positions and proprietary positions). If the Clearing Member does not promptly make a variation payment to the DCO — referred to as a default — the collateral may immediately be liquidated and applied to the obligation. Margin may only be used to meet the default of the Clearing Member posting that margin…*
>
> *Similarly, FCMs will — indeed, are required to — collect collateral from each of their customers, based on each customer's portfolio of positions, to secure the prompt payment of the customer's variation obligations. If a customer fails to fulfil an obligation to the FCM arising out of a swap agreement the FCM clears for the customer, the FCM may use some or all of the value of the collateral that customer has posted to meet that obligation — that is the purpose of the collateral."*

As a practical matter, the US regulations and DCO membership rules will result in payments being made in the form of "initial margin", "variation margin" and "price alignment interest".

[6] ASX Media Release – "Domestic and international banks to work with ASX on OTC derivatives clearing," 20 December 2012

[7] http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-1033a.pdf

a) Initial Margin

The initial margin is collateral that is deposited with the DCO when an OTC derivatives transaction is cleared by a DCO. Initial margin is posted on the initiation of a transaction to ensure that the party posting the margin is able to perform its obligations and covers market risk in the event of default of a customer. The initial margin is calculated with reference to an expectation of future price movements. When initial margin is required and cash is posted, the party that has lodged the initial margin receives interest. The amount of initial margin required is calculated based on an estimate of the potential future adverse price movements under normal market conditions.

In the cleared OTC derivative circumstance, the initial margin will be held by the DCO and interest paid from the DCO to the entity that has posted the margin (i.e. to an FCM on behalf of a market participant).

b) Variation Margin – Mark to Market Alignment

In addition to the initial margin requirements, the DCO and FCM also undertake a daily mark-to-market calculation to re-balance any positions on a daily basis. This effectively results in a variation margin payment to or from the FCM and DCO (depending on the relative position of the underlying contracts).

The background to the regulations describes this process as follows:

> *"To avoid the accumulation of large obligations, the DCO conducts a variation payment and collection cycle at least once a day, and in the case of many DCOs, twice a day.*
>
> *The DCO will first calculate the gain (and corresponding loss) on each contract through a process known as "marking to market," using reported market prices where available, or other means (such as surveys of Clearing Members). The DCO will then aggregate and net the gains and losses for each Clearing Member (separately for proprietary and customer accounts), collect from those Clearing Members with net losses, and pay those Clearing Members with net gains. This process is highly time sensitive: The Clearing Member typically has only one or a few hours between the demand for payment and the time payment is due. Similarly, the Clearing Member FCMs will debit the accounts of those customers who have losses on their transactions, and credit the accounts of those customers who have gained."*

As a matter of industry practice, customers will be required to meet these additional collateral margining positions imposed on the FCM by way of posting collateral directly with the FCM. Notwithstanding that the initial margin will be provided to the FCM, the LSOC model mandates that initial margin is legally segregated (although operationally it is not).

LSOC applies to accounts with both the FCM and with the DCO. Whilst the accounts with the DCO are maintained in the name of the FCM, (as omnibus client accounts), they are legally segregated in the accounts of the FCM for the benefit of their Customer.

c) Price Alignment Interest

Alignment Interest ("PAI") is calculated on the amount of variation margin posted by a participant.

Under the cleared OTC model, generally, variation margin is considered to be the property of the receiving party and that party receives the benefit of investing the variation margin. This is to be contrasted with an uncleared transaction, where generally the variation margin remains the property of the posting party.

PAI is designed to ensure that the party posting the variation margin receives the benefit of that margin. For example, under the LCH, Clearnet rules, "the Clearing House will charge interest on cumulative variation margin received by the Clearing Member and pay interest on cumulative variation margin paid

in by the Clearing Member.[8]" By ensuring that the party that posts the margin continues to receive the benefit of the margin, PAI ensures that there are no systemic differences between the pricing of cleared and uncleared transactions.

Hence, an Australian counterparty with an "in-the-money" OTC derivative transaction will be obliged to pay PAI which will be passed through to the counterparty to the transaction. In practice, the interest will be paid via an FCM (generally acting as agent) to the DCO.

3. The European Clearing Model

The European Commission has implemented mandatory clearing and reporting of transactions in line with the EU's G20 commitment via the so-called European Markets Infrastructure Regulation.

The technical standards are legally binding on all member states without implementation into national law.

The EU approach is in essence a 'principal' model, compared with the US 'agency' model (which is an extension of the 'futures' model).

OTC transactions will continue to be entered into directly between the client and the Clearing Member (or executing broker under a give-up relationship). However, once the clearing broker has entered into or accepted the transaction with the client, an equivalent transaction must also be registered in the client account of the Clearing Member at the clearing house.

4. The Australian Clearing Model

The Australian Government has introduced legislation to amend the Corporations Act 2001 to implement the framework to meet Australia's G20 commitments.

The legislation sets out a legislative framework allowing for the implementation reporting obligations, the requirement to clear standardised OTC derivatives through central counterparties and the use of electronic trading platforms. It is noted that unlike the US and EU models, the Australian rules do not yet require central clearing, or specify the model to be adopted. However, the lack of compulsion at this stage from the Australian Government with respect to the mandatory clearing of trades is based on an expectation that the industry will move towards centralised clearing. To the extent that such an industry shift is not evident, it is expected that the Australian legislation would be modified to compel centralised clearing in respect of certain derivative transactions.

Accordingly, as a matter of practice, the effect of the recent legislative reforms and the ongoing consultation is that certain Australian OTC derivatives (such as Australian interest rate swaps) will need to be centrally cleared, even where both counterparties are Australian and not acting through a foreign permanent establishment.

It is noted above that, at present, there are no Australian DCOs. Accordingly, transactions that are centrally cleared will need to be cleared through a non-resident DCO. Similarly, at present, there are no FCMs that are Australian and hence the Australian parties to a centrally cleared transaction will need to appoint a non-resident FCM.

5. Australian Interest Withholding Tax Considerations

The US and European models will require a substantial increase in the collateralisation of cleared OTC derivative positions. As noted below, the ABA, AFMA and the FSC are concerned that increased interest

[8] LCH Rule 3.5.2

flows from an Australian party to an OTC derivative transaction will result in costs from the application of the Australian interest withholding tax regime. Further, to the extent that an Australian DCO is established in the future, to the extent that such a DCO clears OTC derivatives involving a non-resident counterparty, the DCO may have a withholding tax obligation in respect of payments of interest to the non-resident participant. Importantly, such interest payments may be broader than PAI, for example, interest paid on initial margin posted by a non-resident participant.

5.1. Application of existing law

Division 11A of the *Income Tax Assessment Act 1936* (ITAA 1936) applies to require payments of interest to a non-resident to be subject to Australian interest withholding tax under subsection 128B(5) of the ITAA 1936 if they derive income that consists of 'interest' and the requirements of subsections 128B(2) or (2A) of the ITAA 1936 are satisfied in relation to that income.

Where payments constitute interest or an amount in the nature of interest or in substitution for interest[9], interest withholding tax at the rate of 10 per cent of the gross interest payments will be payable under subsection 128B(5) of the ITAA 1936 and subsection 7(b) of the *Income Tax (Dividend, Interest and Royalties Withholding) Act 1974*). .

Price Alignment Interest – Interest or in the nature of interest

Whilst the term "interest" is not defined in the legislation for income tax purposes, there have been many Australian and international cases that have considered the meaning of 'interest'. An often cited explanation of that term is contained in *Re: Farm Security Act 1944 (Sask)* [1947] SCR 394 at 411-412, [1949] AC 110 (PC).

In that case Rand J commented that:

> *"Interest is, in general terms, the return or consideration or compensation for the use or retention by one person of a sum of money belonging to, in a colloquial sense, or owed to, another...*
>
> *But the definition, as well as the obligation, assumes that interest is referable to a principal in money or an obligation to pay money. Without that relational structure in fact and whatever the basis of calculating or determining the amount, no obligation to pay money or property can be deemed an obligation to pay interest."*[10]

To the extent that PAI represents interest paid on the cumulative variation margin that has been received, it is likely that the payment of any PAI will be subject to Australian interest withholding tax to the extent that it is paid by an Australian to a non-resident, especially under the expanded definition of "interest" under subsection 128A(1AB).

In summary, payments of PAI by Australian entities to foreign residents will be subject to Australian interest withholding tax at a rate of 10% unless one of the exceptions under subsection 128B(3), or reduced under a double tax treaties.

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[9] 'Interest' is defined in subsection 128A(1AB) of the ITAA 1936. Subsection 128A(1AB) of the ITAA 1936 provides that interest includes an amount that is in the nature of interest (paragraph 128A(1AB)(a) of the ITAA 1936), or an amount to the extent that it could reasonably be regarded as having being converted into a form that is in substitution for interest (paragraph 128A(1AB)(b) of the ITAA 1936).

[10] See Hill J in FC of T v BROKEN HILL PTY CO LTD [2000] FCA 1431, quoting *Re: Farm Security Act 1944 (Sask) [1947] SCR 394*

5.2. Australian interest withholding tax: exemptions

Subsections 128B(3) and 128F contain a number of specific exemptions from the imposition of Australian interest withholding tax in respect of interest paid to a non-resident. None of those exemptions will apply in the current circumstances.

In particular, it is noted that the exemption available to global bonds issued to a clearing house contained in section 128F(10) will not be available in respect of PAI on cleared trades as cleared OTC trades will not meet the definition of a global bond or a global note issued to a clearing house.

5.3. Double Tax Agreements: The Financial Institution exemption

A number of Australia's double tax treaties[11] contain an exemption from the payment of interest withholding tax where the payment is made to a financial institution ("FI") and certain other conditions are satisfied.

For jurisdictions in which Australia has entered into a Double Taxation Treaty with a financial institution's exemption, payments of interest are exempt from withholding tax where:

- the recipient of the interest satisfies the definition of a FI;
- the recipient is unrelated to, and dealing wholly independently with the payer of the interest; and
- the interest is not paid as part of an arrangement involving back-to-back loans.

In the case of OTC clearing arrangements undertaken by Australian participants under the US clearing model (either with the DCO directly or through an FCM arrangement where the FCM acts as agent), the FI exemption will generally not be available. It is noted that, depending on the rules of the DCO and the contractual arrangements implemented between the FCM and its clients, the beneficial owner of the PAI may be regarded as either the FCM or the DCO.

Whilst most FCMs will either be wholly owned subsidiaries of banking institutions under the US model or branches of foreign banks under the European clearing model, or where Australian participants clear using an FCM there will be difficulty in obtaining the benefit of treaty protection. In particular, under the US model it will not be possible to demonstrate that the FCM or DCO is a financial institution for treaty purposes, and depending on the specific contractual arrangements that the Australian participant has with the FCM, it is likely that PAI payments will be made on a "back-to-back" basis with the DCO.

The DCOs will not satisfy the definition of "financial institution" as that term is interpreted in TR 2005/5, as the DCO will not be a registered bank and it will not be possible to demonstrate that the DCO "substantially derives its profits from carrying on a business of spread activities".

Notwithstanding that the FCM under the European model may be a branch of a foreign bank, and hence qualify as a financial institution, it is noted that unless that bank is headquartered in a jurisdiction that has an appropriate exemption in its treaty with Australia, the exemption will not apply, i.e. it is the residence of the head office, and not the transacting branch, that is relevant in determining the applicability of the exemption. Further, it is possible the arrangement will constitute a back-to-back arrangement and therefore be excluded from treaty protection.

Even if the financial institution exemption was effective in allowing the payment of interest to either a DCO or an FCM to be paid free of Australian interest withholding tax, the fact that Australia's double

[11] Currently Australia has entered double tax treaties that contain "financial institution" exemption with seven counties – Finland, France, Japan, New Zealand, Norway, South Africa, UK and the US.

taxation treaty network only extends to seven jurisdictions with the relevant exemption, would result in the exemption having limited applicability.

5.4. Implications for Australian Participants

The effect of the above will be that Australian participants whose transactions are required to be cleared pursuant to the regulatory regime or industry practice in any jurisdiction, including the US, UK or Australia will effectively be subject to Australian interest withholding tax on payments of PAI.

Similarly, foreign participants in any Australian framework will be subject to Australian interest withholding tax on amounts of PAI paid from Australia, with the potential for certain participants (such as foreign banks) receiving interest from a future Australian DCO or FCM to obtain the FI exemption, in particular double tax treaties with Australia.

Developed industry practice is that payments of interest by a client entering into a cleared trade are to be made free and clear of any interest withholding tax. This means that Australian participants required to pay interest to non-resident counterparties will bear the cost of any Australian interest withholding tax through being required to gross up their counterparties.

The ABA, AFMA and the FSC are concerned that the imposition of Australian interest withholding tax on Australian entities participating in global OTC markets will have potential implications for any Australian framework, and could disadvantage or dislocate a functioning OTC clearing market for Australian participants.

For completeness, PAI received by Australian participant banks from an FCM or DCO will generally be exempt from foreign interest withholding tax. This is either by virtue of specific local exemptions for cleared derivative trades, broad exemptions within their domestic withholding tax rules that will apply to payments of PAI, the absence of domestic withholding tax rules or an application of the financial institution exemption in the relevant double tax agreement located in one of the seven jurisdictions that have a double tax agreement that contains a Financial Institutions exemption. In section 5 below, we've outlined the withholding tax implications for PAI in relation to collateral for centrally cleared trades in key offshore financial centres.

6. Interest withholding tax considerations offshore

Generally, derivatives markets participants in key global financial centres will not be required to pay interest withholding tax in relation to PAI. A summary of the particular rules in key jurisdictions is provided below.

US

The US exempts from taxation, qualifying "portfolio interest" earned by non-US investors. "Portfolio interest" is exempt from US taxation without regard to the residency of the foreign investor and without regard to any double tax treaty. PAI should qualify as portfolio interest for these purposes and the payments should be exempt provided that the payer and payee are unrelated.

In addition, the US has entered into a number of double tax treaties that apply a zero rate on interest payments and further treaties that include a FI exemption for interest withholding.

UK

In general, the UK Income Tax Act 2007 requires persons making payments of interest having a UK source to withhold tax at a rate of 20%. There are, however, certain key domestic exceptions from the

obligation to withhold UK tax which will often be available in relation to payments of PAI by UK participants on collateralised positions in respect of OTC cleared trades, as follows:

(a) Interest paid by banks

No UK withholding tax is applied on interest paid by a bank (which can include both a UK bank and a UK branch of an overseas bank) if that payment is made in the ordinary course of its business.

(b) Short interest

The obligation to withhold UK income tax on payments of interest only applies to "yearly" interest. Interest payable on short-term debt (broadly speaking, debt which both pursuant to its terms and in light of the intention of the parties is not capable of lasting for 12 months or more) is not subject to UK withholding tax.

The UK also has a specific exemption from IWT for yearly interest. Even if the payments were considered not to be short interest, Section 883 of the Income Tax Act 2007 provides an exemption from interest withholding tax on payments of annual interest in respect of cleared trades.[12]

Hong Kong

Hong Kong does not impose withholding tax on interest payments.

Singapore

Singapore has a withholding tax exemption regime for certain specified entities, which include licensed banks and finance companies and certain financial institutions. With effect from 1 April 2011, a withholding exemption is granted to interest payments made by specified entities to all non-residents (excluding permanent establishments in Singapore), if the payments are made for the purpose of the trade or business of the specified entity.

The 2012 Budget further enhanced this broad based exemption. With effect from 17 February 2012, the exemption will also apply to payments made by specified entities to all non-residents, including permanent establishments in Singapore.

7. Proposed legislative amendment

In recognition of the importance of the international financial markets to the Australian financial system and the competitive disadvantage that would result from the imposition of Australian interest withholding tax on cleared trades by Australian based participants and/or Australian based DCOs or FCMs, the ABA, AFMA and the FSC suggest that it is desirable for Australia to implement an interest withholding tax exemption.

A way to achieve the desired outcome would be through the following wording which could find an appropriate inclusion at subsection 128B(3) of the ITAA 1936:

> *128B(3)(m) income in respect of swaps transacted through a recognised derivatives clearing organisation that relates to:*
>
> *(i) interest paid to or by a recognised clearing and settlement facility; or*
> *(ii) interest paid to or by a futures commission merchant (or equivalent organisation) acting as either principal or agent*

[12] http://www.legislation.gov.uk/ukpga/2007/3/section/886

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"recognised clearing and settlement facility" means an organisation licensed under Part 7.3 of the Corporations Act (2001) or named in regulations made for the purposes of this definition.

"futures commission merchant" means a participant that is registered with a recognised clearing and settlement facility

The ABA, AFMA and the FSC recommend that these rules be implemented with effect to transactions entered after 1 October 2012.