2015

EXPOSURE DRAFT

MODERNISING THE OFFSHORE BANKING UNIT REGIME

EXPLANATORY MATERIAL

(Circulated by the authority of the
Treasurer, the Hon J. B. Hockey MP)

Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
Commissioner	Commissioner of Taxation
DBU	Domestic Banking Unit
OB	Offshore banking
OBU	Offshore Banking Unit
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
NANE	Non-assessable non-exempt

Chapter 1
Modernising the Offshore Banking Unit Regime

Outline of chapter

1.1 The Exposure Draft contains a number of reforms to modernise the Offshore Banking Unit (OBU) regime. The reforms include measures implementing recommendations of the *Australia as a Financial Centre – Building on Our Strengths* report by the Australian Financial Centre Forum chaired by Mark Johnson. The reforms also include targeted amendments to address a number of integrity concerns with the existing regime.

Context of amendments

1.2 The amendments in the Exposure Draft are made to the OBU regime contained in Division 9A of the *Income Tax Assessment Act 1936* (ITAA 1936). All legislative references in this Chapter are to the ITAA 1936 unless otherwise specified.

1.3 The regime is designed to provide tax incentives for highly mobile financial sector activities to be undertaken within Australia. These activities broadly include:

- financial intermediation between offshore lenders and offshore borrowers; and
- providing other financial services to offshore investors investing outside Australia.

1.4 Assessable income from eligible offshore banking (OB) activities is effectively subject to a tax rate of 10 per cent, rather than the corporate tax rate of 30 per cent. This is achieved by only bringing to account an 'eligible fraction' of income from OB activities and associated expenses (section 121EG).

1.5 In addition, under Division 11A, interest payments made by OBUs when borrowing from offshore are not subject to interest withholding tax when the borrowed funds are used to carry on eligible OB activities (sections 128GB and 128NB).

Operation of the existing law

1.6 An OBU is a notional division or business unit of an Australian entity that conducts OBU activities. To be considered as an OBU, an entity must be declared by the Treasurer as an OBU.

1.7 An OBU receives concessional tax treatment in respect of eligible OB activities, provided additional criteria are met. The list of eligible OB activities is provided at paragraph 1.22.

Trading activity

1.8 One kind of eligible OB activity is a trading activity (paragraph 121D(1)(c)). Amongst other things, trading activity includes trading with an offshore person in shares, securities and units of an offshore entity, as well as options or rights in respect of these shares, securities and units (subsection 121D(4)).

1.9 As a result, trading in the shares, securities or units (or the associated options or rights) of an offshore subsidiary may constitute an eligible OB activity.

1.10 This has the effect of allowing the conversion of ineligible non-OB activities to eligible OB activities. That is, the offshore subsidiary may undertake ineligible activities and the OBU may claim the same economic benefit as assessable OB income by trading in the shares it owns in the subsidiary.

The choice principle

1.11 A taxpayer that is an OBU may engage in activities that are not eligible OB activities. These activities are said to be undertaken by the taxpayer's domestic banking unit (DBU) – another notional division of the entity. The taxpayer must keep separate accounting records for their OBU and DBU activities (subsection 262A(1A)).

1.12 The Commissioner of Taxation (the Commissioner) has expressed the view that a taxpayer is entitled to make the choice, at the time of entering into an OB activity transaction, to record the transaction in its non-OBU accounts (ATO TD 93/135). A consequence of this choice is that any income from the transaction is not entitled to concessional taxation as assessable OB income. Similarly, expenses or losses on the transaction are entitled to deductions at the full corporate tax rate.

1.13 As the transaction is treated as not being an OB activity, the associated income does not risk the taxpayer failing the purity test in section 121EH if the activity was financed through non-OB money.

1.14 Furthermore, by choosing to attribute offshore borrowing to its DBU, the taxpayer can avoid a recoupment of exempted withholding tax by not claiming the exemption under section 128GB (see section 128NB of the ITAA 1936, and the *Income Tax (Offshore Banking Units) (Withholding Tax Recoupment) Act 1988*). This choice is necessary where, for example, the taxpayer intends to apply offshore borrowings to its domestic lending activities.

1.15 In 2007, the Commissioner released a discussion paper that considered the withdrawal of the TD 93/135, although the determination has not been withdrawn. The availability of the choice principle avoids inadvertent breaches of the purity test and the imposition of withholding tax recoupment penalties. The status of the choice principle as an administrative interpretation creates some uncertainty for participants in the regime.

Allocation of expenses

1.16 The expenses of a taxpayer with an OBU must be allocated between the taxpayer's DBU and OBU. Deductions for expenses allocated to each unit are deductible at a 30 per cent and 10 per cent tax rate respectively.

1.17 Section 121EF uses a number of concepts to categorise deductions:

- Allowable OB deductions, which include:
  - exclusive OB deductions, which relate only to deriving assessable OB income;
  - general OB deductions; or
  - apportionable OB deductions.
- Loss deductions (per Division 36 of the *Income Tax Assessment Act 1997* (ITAA 1997)).
- Exclusive non-OB deductions, which relate only to non-OB assessable income.

1.18 Deductions that do not relate exclusively to assessable OB or assessable non-OB income (and are not loss or apportionable deductions)

are allocated to the OBU on the basis of a statutory formula. The formula allocates these deductions according to the proportion of the taxpayer's adjusted assessable income (assessable income less exclusive interest deductions) that consists of adjusted OB income.

1.19 The use of adjusted assessable income is intended to prevent distortions arising from low-margin OB activities (see the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 4) 1992, paragraphs 32-33).

1.20 Apportionable deductions, as defined in subsection 6(1), relate to neither assessable OB income nor assessable non-OB income and are allocated according to a separate statutory formula in subsection 121EF(5).

1.21 Section 121EF does not expressly refer to deductions allowable for expenses incurred in deriving non-assessable non-exempt (NANE) income, for example, deductions for interest costs under section 25-90 of the ITAA 1997. As such, the current law treats these deductions as deductions to be allocated according to the existing statutory formula for determining general OB deductions.

The list of eligible OB activities

1.22 The list of eligible activities is contained in section 121D of the ITAA 1936. The current list includes:

- borrowing and lending activities;
- guarantee-type activities;
- trading activities;
- eligible contract activities;
- investment activities;
- advisory activities;
- hedging activities; and
- activities prescribed in the regulations.

1.23 Certain requirements apply before a listed activity is eligible to produce concessional OB income for the OBU. Section 121EA ensures that the OBU undertakes the OB activities within Australia. Furthermore, many of the activities are only eligible when undertaken with

counterparties that meet the definition of 'offshore person' in section 121E.

1.24 The list of eligible activities has remained constant since 1998. Furthermore, no regulations have been made prescribing additional activities relevant to modern commercial practice.

Internal financial dealings

1.25 Section 121EB treats certain permanent establishments as separate persons. This may include, for example, an offshore branch of an Australian entity.

1.26 This enables an OBU to deal with its offshore permanent establishment as a separate entity when conducting OB activities, so that the requirement of dealing with an 'offshore person' is met.

1.27 As a result, the existing law contemplates that an OBU may source funding internally from a related party, such as an offshore branch.

Summary of new law

1.28 The Exposure Draft implements a number of reforms to the OBU regime. These include:

- limiting the availability of the OBU concession in certain circumstances where it could otherwise be used to convert ineligible activity into eligible OB activity;
- codifying the choice principle to remove uncertainty for taxpayers;
- introducing a new method of allocating certain expenses between the operations of a taxpayer's DBU and OBU;
- modernising the list of eligible OB activities; and
- treating internal financial dealings (for example, between an Australian bank and its offshore branch) as if they were on an arm's length basis.

Comparison of key features of new law and current law

New law	*Current law*
The range of eligible trading activities will exclude trading in subsidiaries or other entities where the OBU holds a 10 per cent or more interest. It will also exclude trading in interests that are not 'held for trading' according to the OBU's accounting records.	An OBU can convert ineligible activity into eligible OB activity, by undertaking non-eligible activities through an offshore subsidiary, and trading in the shares, securities and units of the subsidiary (which is itself an eligible OB trading activity).
The 'choice principle' will be clarified and codified in legislation.	The 'choice principle' is embodied in a tax determination issued by the Commissioner.
Certain deductions that do not relate exclusively to OB or non-OB income must be apportioned to the OBU to the extent that they relate to the production of OB income.	Certain deductions that do not relate exclusively to OB or non-OB income must be apportioned to the OBU using a statutory formula based on adjusted income.
The list of eligible OB activities will be modernised to add certain mobile activities.	The law currently lists eligible OB activities, although this list has not been updated since 1998.
Internal financial dealings will be treated as being on an arm's length basis for the purpose of calculating an OBU's OB income or allowable OB deductions.	There is no requirement within the OBU regime that internal financial dealings be on an arm's length basis.

Detailed explanation of new law

Part 1: Trading activity

1.29 Part 1 of the Exposure Draft limits the eligible trading activity in certain situations.

Total participation interest of 10 per cent or more

1.30 Under the existing law, an OBU may trade with an offshore person in the shares, securities or units of an offshore subsidiary (paragraphs 121D(1)(c), 121D(4)(a) and (b), and section 121ED). This trading activity may constitute an eligible OB activity, even if the subsidiary is undertaking ineligible non-OB activities.

1.31 This makes it possible to convert ineligible non-OB activities to eligible OB activities, by allowing the OBU to undertake ineligible

activities through an offshore subsidiary, and trading in the interests of the subsidiary.

1.32 To address this integrity concern, the amendments limit the scope of the eligible trading activity category. Trading in things, such as shares, that affect the total participation interest in another entity will no longer be an eligible OB activity if the total participation interest is 10 per cent or more just before the trading activity occurred. ***[Exposure Draft, items 5 and 10, paragraph 121D(1)(c) and subsection 121D(4A) of the ITAA 1936]***

1.33 This is intended to ensure that trading in subsidiaries, or other entities where the OBU holds an interest of at least 10 per cent, no longer attracts concessional tax treatment.

1.34 'Total participation interest' is an existing concept used in section 960-180 of the ITAA 1997. It includes both direct and indirect participation interests.

1.35 However, for the purposes of the new law, any rights that the OBU may have on winding-up are disregarded in determining the total participation interest. The rights on winding-up may vary considerably from other interests and can therefore distort the participation test. ***[Exposure Draft, item 10, subsection 121D(4B) of the ITAA 1936]***

Example 1.1: change in participation interest

On 1 July 2015, AusOBU holds a total participation interest in an offshore company, Forco, of 20 per cent.

On 3 July 2015, AusOBU buys more shares in Forco, taking its total participation interest to 25 per cent. Under the new law, the purchase of the shares will not be an eligible OB trading activity, because AusOBU holds a participation interest of at least 10 per cent.

On 6 July 2015, AusOBU sells some of its shares in Forco, taking its total participation interest to 7 per cent. Under the new law, the sale of the shares will not be an eligible OB trading activity because AusOBU's total participation interest just before the sale was more than 10 per cent.

Example 1.2: no net change in participation interest

On 1 July 2015, AusOBU holds a total participation interest in an offshore company, SJP Ltd, of 20 per cent.

On 3 July 2015, AusOBU buys more shares in SJP Ltd, taking its total participation interest to 25 per cent. Later that day, AusOBU decides to sell some shares in SJP Ltd, so that its total participation interest returns to 20 per cent.

Under the new law, neither the purchase nor sale of the shares is an eligible OB trading activity. Even though there is no net change in the total participation interest, the new law considers whether the thing (in this case, the shares) affected the total participation interest, rather than whether the *trade* of the thing affected the total participation interest.

Participation interests not held for trading

1.36 Trading in a thing that affects the total participation interest will not be an eligible OB activity if any of the traded interest was not recorded in the OBU's accounting records as held for trading in accordance with the accounting standards. ***[Exposure Draft, items 5 and 10, paragraph 121D(1)(c) and subparagraph 121D(4A)(b)(ii) of the ITAA 1936]***

1.37 This rule applies even if the total participation interest is less than 10 per cent just before the trading activity.

1.38 This rule is intended to clarify that the 'trading activity' limb applies to genuine trading activity, as evidenced by the OBU's accounting records.

1.39 This is determined by reference to the accounting standards issued by the Australian Accounting Standards Board. Currently, accounting standard *AASB 9 Financial Instruments* defines 'held for trading' as a financial asset or financial liability that:

> (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
>
> (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
>
> (c) is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

Example 1.3: not held for trading

AusOBU holds an investment in a Singaporean company, MP Ltd. This investment is not recorded as being 'held for trading' in AusOBUs accounting records. AusOBU's acquired this investment as part of its long-term strategy to increase its exposure to the Singaporean market, rather than for the principal purpose of selling or repurchasing it for short term gains.

Any trading of AusOBU's investment will not be an eligible OB trading activity.

Part 2: The choice principle

1.40 Part 2 of the Exposure Draft codifies the choice principle articulated in TD 93/135.

1.41 A taxpayer may choose to treat a transaction that is an eligible OB activity as if it was ineligible. ***[Exposure Draft, item 25, subsection 121EAA(1) of the ITAA 1936]***

1.42 A taxpayer may make this choice by entering the transaction in their non-OB accounting records rather than the OB accounting records maintained under subsection 262A(1A). ***[Exposure Draft, items 17 and 25, section 121C and subsection 121EAA(2) of the ITAA 1936]***

1.43 This choice must be made contemporaneously with the time the transaction is entered into. The record should be made as soon as practicable after the taxpayer enters into the transaction. This is consistent with the existing interpretation of the obligation to maintain records generally (section 262A and ATO TR 96/7, paragraphs 49-50).

1.44 Making the choice in relation to one transaction will have an impact on the treatment of other transactions if the transactions are part of the same scheme. If a taxpayer choses to treat a particular transaction that is an eligible OB activity as if it were ineligible, all other transactions within the same scheme are treated as if they are ineligible. ***[Exposure Draft, item 25, subsection 121EAA(3) of the ITAA 1936]***

Example 1.4: Asymmetric swap scheme

AusOBU enters into an asymmetric swap scheme with an offshore counterparty. The scheme comprises of two swaps that take opposite positions on an underlying commodity.

Under the new law, AusOBU must make the same choice in respect of both swaps. That is, AusOBU cannot choose to record one swap in its OB accounting records, and the other swap in its DBU accounting records.

1.45 Once made, the choice is generally irrevocable. The choice may only be revoked where the choice was made in error. That is, the choice may be revoked where the recording was inadvertent and did not give effect to the actual intent of the taxpayer at that time. A revocation in these circumstances is achieved by recording the transaction in the taxpayer's OB accounting records. ***[Exposure Draft, item 25, subsection 121EAA(4) of the ITAA 1936]***

1.46 If a choice is revoked due to a mistake, the choice must also be revoked in relation to any other component of the scheme. This compliments the rule discussed at paragraph 1.44. ***[Exposure Draft, item 25, subsection 121EAA(5) of the ITAA 1936]***

Part 3: Allocation of expenses

1.47 Part 3 of the Exposure Draft sets out a new framework for allocating deductions that relate to both OB and non-OB income, such as rent on a building used for both OBU and DBU activities, between the taxpayer's OBU and DBU.

1.48 Under the current law, certain deductions must be apportioned using a statutory formula, which is based on adjusted income allocated to the taxpayer's OBU and DBU.

1.49 The effect of the amendments is to replace the statutory formula with a rule that the unallocated deduction is allocated to the taxpayer's OBU to the extent that it relates to OB income. This is achieved by amending the definition of a general OB deduction. The new rule draws on the apportionment principles applicable to the general deduction provision in section 8-1 of the ITAA 1997. ***[Exposure Draft, item 65, subsection 121EF(4) of the ITAA 1936]***

1.50 The definition of a general OB deduction under the new law requires that the deduction relate to OB income, rather than 'assessable' OB income. This is intended to cater for deductions that relate to expenses incurred in deriving NANE income, as well as assessable income.

1.51 For example, deductions claimed under section 25-90 of the ITAA 1997 could be apportioned using this new rule. Section 25-90 deductions relate to interest and other similar expenses incurred in deriving dividends that are NANE income under section 23AJ of the ITAA 1936.

1.52 To support the new definition of a general OB deduction, the new law inserts a definition of 'OB income' and modifies the current definition of 'assessable OB income'. ***[Exposure Draft, items 55 and 60, section 121EDA and subsection 121EE(2) of the ITAA 1936]***

1.53 The definition of 'OB income' is based on the existing definition of 'assessable OB income', with appropriate modifications. The definition of 'assessable OB income' has been modified to be so much of OB income as is assessable.

Part 4: Eligible activities

1.54 Part 4 of the Exposure Draft modernises the existing list of eligible OB activities in section 121D of the ITAA 1936. This ensures that the OBU regime operates as intended by attracting mobile financial sector activity.

Unfunded lending activities

1.55 The list of eligible activities includes lending money to an offshore person. To this, the amendments add the activity of making an unfunded commitment to lend money. ***[Exposure Draft, item 100, paragraph 121D(2)(b) of the ITAA 1936]***

1.56 Unfunded lending is where an OBU makes funds available to an offshore person but the funds are not drawn down, or are yet to be drawn down. Income in the form of fees for making the credit available is mobile income and will be treated accordingly as assessable OB income.

1.57 The new element of the activity will be subject to the existing currency restrictions in paragraph 121D(2)(b).

Syndicated lending activities

1.58 A syndicated lending arrangement involves a number of financial institutions lending to a borrower. Syndicated arrangements are common in large capital raisings. In addition to committing to lend their own capital, an OBU may be involved in arranging contributions from a syndicate of other lenders. The OBU may also be involved in underwriting some of the credit risk. The OBU will earn a fee for these services.

1.59 The position of arranger within a syndicate is highly mobile. An amendment is made to include undertaking the services of an arranger in the list of eligible OB activities. This amendment ensures that any such service is an eligible OB activity regardless of whether it also falls within the scope of paragraph 121D(3)(c). ***[Exposure Draft, item 105, paragraph 121D(2)(e) of the ITAA 1936]***

Guarantee activities and connections with Australia

1.60 Subsection 121D(3) lists four guarantee activities as eligible OB activities. Three of the activities are restricted to (relevantly) activities that are conducted wholly outside Australia, property located outside Australia and events that can only happen outside Australia.

1.61 These strict restrictions limit the application of the concession and are inappropriate where the connection between Australia and the relevant activities is not significant. Accordingly, an amendment is made to require only that the activity not relate, to a material extent, to a place within Australia. ***[Exposure Draft, items 80, 115 and 120, section 121C and subsection 121D(3) of the ITAA 1936]***

1.62 The materiality threshold requires a comparison between, for example, the activities undertaken in Australia and those conducted elsewhere. In relation to property, the comparison is between the intended use of the property, either in Australia or elsewhere. Similarly, in the case of events, it is necessary to consider the likelihood of the event occurring in Australia.

1.63 This materiality threshold is not intended to be satisfied by slight or theoretical connections to Australia. It is not necessary, however, to show that the connection is predominant before the threshold is satisfied.

Example 1.5 Material connections to Australia

An OBU underwrites a risk for an offshore person in relation to the insurance of an aeroplane. The aeroplane spends the majority of its time flying between international destinations. On occasion, the plane will fly to and from Australia, although this is not a significant route in the context of its global operations.

The insurance covers property that is used within Australia and elsewhere and includes coverage for risks that could occur in either Australia or elsewhere. However, the likelihood of an insured event occurring within Australia is not material in the context of the scope of the policy, nor is the use of the property within Australia material. The underwriting is an eligible OB activity.

Trading in commodities

1.64 Subsection 121D(4) provides that certain trading activities are eligible OB activities. Trading activities include trading in a number of precious metals with offshore persons.

1.65 Amendments are made to provide that trading in any commodity with an offshore person is an eligible OB activity where it is incidental to an eligible contract activity. ***[Exposure Draft, item 130, subsection 121D(4) of the ITAA 1936]***

1.66 The purpose of this amendment is to allow certain commodity trading activities to be eligible OB activities where they are undertaken to hedge positions in commodity derivatives. However, it is not necessary that the activity involve hedging for it to be eligible.

1.67 Commodity trading can be undertaken through commodity exchanges or over-the-counter facilities.

Securities lending and repurchase agreements

1.68 Amendments are made to the definition of eligible contract activity to include entering into securities lending and repurchase agreements in the list of eligible OB activities. ***[Exposure Draft, items 75, 80, 85 and 155, sections 121C and 121DB, and paragraph 121D(1)(d) of the ITAA 1936]***

1.69 Repurchase arrangements involve the sale and repurchase of securities. In most cases, the repurchase price will be higher than the sale price or forward value of the securities. The increase reflects the cost (repo rate) of the original purchaser providing credit to the original owner. Securities lending arrangements, in contrast, are often motivated by the borrower wishing to use the securities in another arrangement, for example short-selling, in return for a fee to the lender.

1.70 Repurchase arrangements share many of the commercial features of a secured loan, where the securities sold act as collateral. Similarly, securities lending has many of the commercial features of lending and trading in securities. This amendment will provide certainty for these arrangements.

Non-deliverable forward foreign currency contracts

1.71 Paragraph 121D(4)(e) includes trading in non-Australian currencies, or related options and rights, with any person (including Australian residents) as an eligible trading activity. This facilitates trading in forward foreign currency contracts, including as a hedging mechanism.

1.72 A non-deliverable forward foreign currency contract is an instrument used to hedge foreign exchange exposures. The contract works in a similar way to a standard forward foreign currency contract, except the obligations are settled in another currency (settlement being the difference between an agreed notional exchange rate and the forward exchange rate). This is necessary where the relevant currency is not widely traded.

1.73 Under the contract, no rights are created with respect to the foreign currency, which means that the activity is outside the scope of the existing currency trading activity (ATO ID 2011/27). A non-deliverable forward foreign currency contract, therefore, is currently only an eligible OB activity where it is entered into with an offshore person (subsection 121D(5)).

1.74 An amendment is made to allow trading in these contracts with any person to be an eligible OB activity. This will align the tax treatment of non-deliverable forward foreign currency contracts with equivalent foreign exchange contracts. ***[Exposure Draft, item 125, paragraph 121D(4)(aa) of the ITAA 1936]***

1.75 A further amendment is made to allow OBU's to treat entering into such a contract with any person as an eligible OB activity. ***[Exposure Draft, items 75, 135 and 155, subsection 121D(5), and sections 121C and 121DB of the ITAA 1936]***

Portfolio investment asset percentages

1.76 Subsection 121D(6A) includes managing a portfolio investment in the list of eligible OB activities. A condition of this activity is that the portfolio's average Australian asset percentage not exceed 10 per cent (paragraph 121D(6A)(f)). The average Australian asset percentage is defined in subsections 121DA(2) and (4).

1.77 This requirement limits the accessibility of the activity and the concession, preventing some OBUs from marketing suitable funds to offshore counterparties. Movements in the value of a fund's assets may inadvertently tip the fund above the threshold, making the entire fund ineligible as an OB activity.

1.78 The limitation is unnecessary to achieve the object of limiting the availability of the OBU concession to offshore investments. The income allocation rules ensure that any income referable to the Australian asset component of the fund is not included in an OBU's assessable OB income (subsection 121EE(3A)).

1.79 An amendment is made to remove the requirement in paragraph 121D(6A)(f). ***[Exposure Draft, items 140 and 145, paragraphs 121D(6A)(e) and (f)of the ITAA 1936]***

Advice on disposal of investments

1.80 Subsection 121D(7) makes the giving of investment or financial advice an eligible activity. A limitation applies in the case of advice relating to the making of an investment. In those circumstances, the advice must relate to an investment that is outside Australia. Other advice is not limited in this way. However, there has been uncertainty in the interpretation of this provision with respect to advice provided in relation to the disposal of investments.

1.81 An amendment is made to clarify that advisory activities includes the provision of advice in relation to the disposal of an

investment, regardless of its location. ***[Exposure Draft, items 90, 150 and 155, paragraph 121D(1)(f), subsection 121D(7) and section 121DC of the ITAA 1936]***

Leasing activities

1.82 Amendments are made to add leasing activities involving offshore persons to the list of eligible OB activities. ***[Exposure Draft, items 95 and 155, paragraph 121D(1)(g) and section 121DD of the ITAA 1936]***

1.83 The addition of leasing activities is intended to give greater flexibility to OBUs in recognition of the fact that many leasing arrangements have similar commercial features to existing OB activities such as lending.

1.84 Using the concept of lease from section 51AD of the ITAA 1936, a lease is any arrangement that includes the owner of property granting a right to use the property in another person.

1.85 The activity will not apply to hire-purchase arrangements that are recharacterised under division 240 of the ITAA 1997 as notional sale and loan arrangements. Notional loan arrangements may nevertheless be eligible OB activities under subsection 121D(2).

1.86 The leased property must not be used to a material extent within Australia (see paragraph 1.62 and Example 1.5 for discussion of this condition).

1.87 The activity will cover both operating leases and finance leases.

Part 5: Internal financial dealings

1.88 Part 5 of the Exposure Draft treats internal financial dealings as being on an arm's length basis.

1.89 Under the existing law, an OBU may source funding internally from a related party (section 121EB). This could include an offshore branch of the Australian bank.

1.90 The existing law does not stipulate that the internal funding is to be priced on an arm's length basis. In addition, the transfer pricing rules in Division 815 of the ITAA 1997 may not apply.

1.91 To address this, the new law provides that the OBU's OB income or allowable OB deductions are treated as being those amounts that would be included or allowed, were the internal parties dealing with each other at arm's length. ***[Exposure Draft, item 157, subsection 121EB(4) of the ITAA 1936]***

Consequential amendments

1.92 Amendments are made to references to 'OB activity' that are consequential to the codification of the choice principle in Part 2. ***[Exposure Draft, items 15, 20 and 30, paragraph 121B(2)(a), subsection 121D(1) and subsection121EB(1) of the ITAA 1936]***

1.93 Amendments are made that are consequential to the allocation of expenses in Part 3. ***[Exposure Draft, items 35, 40, 45, 47, 50 and 70, subsection 6(1), paragraphs 121B(2)(b) and 121EH(a), and sections 121C and 121E of the ITAA 1936]***

Application provision

1.94 The amendments made by Exposure Draft apply in relation to income years starting on or after 1 July 2015. ***[Exposure Draft, item 160]***