EXPLANATORY STATEMENT

Issued by authority of the Assistant Treasurer

Income Tax Assessment Act 1997

Treasury Laws Amendment (2019 Measures No. #) Regulations 2019

Section 909-1 of the *Income Tax Assessment Act 1997* (the Act) provides that the Governor-General may make regulations prescribing matters required or permitted by the Act to be prescribed, or necessary or convenient to be prescribed for carrying out or giving effect to the Act.

The *Treasury Laws Amendment (2019 Measures No. #) Regulations 2019* (the Regulations) amend the *Income Tax Assessment Regulations 1997* (the ITAR 1997) to align the tax treatment of Tier 2 capital instruments convertible into mutual equity interests (MEI) with those convertible into ordinary shares. The alignment of this treatment aims to remove a barrier to accessing capital and help to increase competition in the banking sector, ultimately providing more choices for customers.

Background to the new regulations

In preparing the *Report on Reforms for Cooperatives, Mutuals and Member-owned Firms* (July 2017) (the Report), the independent facilitator, Mr Greg Hammond OAM, undertook consultations with stakeholders with significant interests. A copy of the Report is available on the Publications page of the Treasury website. The Regulations deliver on the Government's agenda to increase competition in Australia's banking system by implementing recommendation 7 of the Report, which will rectify the current disadvantage experienced by mutually-owned authorised deposit-taking institutions (ADIs) in comparison to their competitors. This disadvantage is caused by current operation of the ITAR 1997 which treats Tier 2 capital instruments convertible into ordinary shares differently to Tier 2 capital instruments convertible into MEI.

The prudential capital adequacy requirements

To implement the Basel III capital reforms, the Australian Prudential Regulation Authority (APRA) required Tier 2 capital instruments issued by ADIs to include a 'non-viability condition' as a loss-absorption mechanism. The non-viability condition, as it was originally introduced by APRA, required capital instruments to be either (i) written off; or (ii) converted to common equity where APRA or a comparable foreign regulator considered the issuer, or its parent, would be non-viable or require an injection of public sector funding without such a write off or conversion.

As mutually-owned ADIs (credit unions, building societies and mutual banks) cannot issue ordinary shares, APRA revised its prudential standards further to allow these ADIs to issue MEI. This was intended to give mutually-owned ADIs greater flexibility in their capital management. It also meant that these entities could comply with the non-viability condition by either writing off their regulatory capital instruments or converting those instruments into MEI. Although APRA's prudential

standards were revised to incorporate MEI, the taxation of MEI has not yet been aligned with that of ordinary shares.

Taxation of capital instruments convertible into ordinary shares

Division 974 of the Act provides rules to distinguish between debt and equity for various income tax purposes. One important implication of the debt-equity distinction is that returns on debt interests may be tax deductible but are not frankable, while returns on equity interests may be frankable but are not deductible. An instrument cannot be concurrently a debt interest and an equity interest for income tax purposes.

The characterisation of a capital instrument as a debt interest as opposed to an equity interest broadly depends on whether the issuer has, in substance or effect, a non-contingent obligation to repay the investment. Paragraphs 974-135(8)(a) and (b) of the Act provide that regulations may make further provisions relating to what constitutes, and what does not constitute, a non-contingent obligation for the purposes of section 974-135 of the Act.

Prior to the insertion of regulation 974-135F in the ITAR 1997, the requirement to include a non-viability condition would have prevented regulatory capital instruments from being treated as debt for tax purposes. This is because the non-viability condition would otherwise create a contingent obligation to repay the investment. Regulation 974-135F, which commenced on 12 December 2012, facilitated debt tax treatment of Tier 2 capital instruments by overlooking the contingency that is created by imposing the non-viability condition on these capital instruments. That is, Tier 2 capital instruments do not cease to be debt interests for income tax purposes merely because they are subject to a non-viability condition. This removed uncertainty concerning the tax treatment of these capital instruments given they resemble characteristics of both debt and equity interests.

Mutually-owned ADIs have not, however, been able to issue Tier 2 capital instruments convertible to MEI in a cost effective manner as these instruments are considered as (contingent) equity interests rather than (non-contingent) debt interests for income tax purposes. This is because the commencement of regulation 974-135F predated the introduction of MEI and accordingly only refers to conversion to ordinary shares. The Regulations rectify this by amending regulation 974-135F so that capital instruments convertible into MEI are treated in the same manner as capital instruments convertible into ordinary shares.

While facilitating the debt treatment of capital instruments issued by mutually-owned ADIs, the Regulations do not deem such instruments to be debt interests or make returns on the instruments tax deductible.

A short form RIS was completed OBPR reference 22702.

Details of the Regulations are set out in the Attachment A.

The Regulations commence on the day after this instrument is registered on the Federal Register of Legislation.

Attachment A

Details of the Treasury Laws Amendment (2019 Measures No. #) Regulations 2019

Clause 1 – Name of Regulations

This section provides that the title of the Regulations is the *Treasury Laws Amendment (2019 Measures No. #) Regulations 2019.*

Clause 2 – Commencement

This section provides that the Regulations commence on the day after registration.

Clause 3 – Authority

This section provides that the Regulations are made under the *Income Tax Assessment Act 1997* (the Act).

Clause 4 – Schedules

This section provides that the *Income Tax Assessment Regulations 1997* (the Principal Regulations) are amended as set out in Schedule 1.

Schedule 1 – Amendments

Item 1 inserts a new regulation 910-1.11 into Part 5 of the Principal Regulations which confirms that the Regulations only apply to relevant term cumulative subordinated (Tier 2) notes issued on or after the date the Regulations are registered. That is, the Regulations do not apply to any Tier 2 notes convertible into mutual equity interests already on issue.

Item 2 replaces subregulation 974-135F(4) to expand the definition of ***non-viability condition***. Previously, a non-viability condition was defined only by reference to notes being written off or converted into ordinary shares of the issuer or a parent of the issuer upon the occurrence of a ***non-viability trigger event***, which is defined in subregulation 974-135F(5).

The new subregulation 974-135F(4) includes a third alternative and refers to notes being converted into MEI of the issuer or a parent of the issuer upon the occurrence of a non-viability trigger event. This takes into account the new prudential standards issued by APRA, which allow mutually-owned ADIs to directly issue mutual equity interests.

Without the expanded definition, the non-viability condition may cause the obligation to pay principal or interest under the terms of the note to be considered to be contingent. This would preclude notes issued by mutually-owned ADIs from being a debt interest for taxation purposes.

Item 3 inserts a definition of MEI at subregulation 974-135F(6) as having the same meaning as in section 11CAA of the *Banking Act 1959*. Section 11CAA provides that MEI has the same meaning as in the prudential standards. The relevant standard is the *Banking (Prudential Standard) Determination No. 4 of 2017 - Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*. The *Banking Act 1959* incorporates this definition by reference to ensure consistency in the application of the definition, and it is appropriate to do so given that the prudential standards are

legislative instruments which are freely available to the public and easy to locate on the Federal Register of Legislation at legislation.gov.au or the APRA website.