31 January 2020

William Potts
Manager
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: William.Potts@treasury.gov.au

Dear William

Tax Integrity – Clarifying the Operation of the Hybrid Mismatch Rules

Introduction

The Australian Banking Association (**ABA**) is the principal industry body for the Australian banking sector. The ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services.

Treasury has released exposure draft amendments to the hybrid mismatch rules in Division 832 of the *Income Tax Assessment Act 1997* (Cth), contained in the exposure draft *Treasury Laws Amendment (Measures for Consultation) Bill 2019: Hybrid Mismatch Rules* (**ED**).[1]

The ABA welcomes the opportunity to provide submissions on one particular aspect of the ED, being the proposed amendments to s.207-158 in the context of how that provision applies in relation 'Additional Tier 1' (**AT1**) instruments, in particular where issued out of Australian banks' head offices in Australia. We would also welcome the opportunity to meet with Treasury to discuss our submissions in due course.

Executive summary

In summary:

- as Treasury is aware, the intended target of s.207-158 was offshore so-called 'deductible/frankable' instruments;
- the manner in which overseas branch tax calculations are required to be done in a limited number of jurisdictions in which the major Australian banks currently have branches has given rise to the current uncertainty in relation to s.207-158. There is nothing to indicate that s.207-158 was intended to apply to domestic issuances of AT1 instruments as a result of such notional overseas tax calculations;
- we acknowledge and thank Treasury for trying to adopt a practical approach in the ED to allow domestic AT1 instruments to continue to be issued with issuers having a mechanism to provide some certainty to investors as regards to their ability to claim franking benefits;

[1] Unless otherwise stated, all legislative references in this letter are to provisions of the *Income Tax Assessment Act 1997* (Cth) or the proposed amendments contained in the ED, as applicable.

Australian Banking Association

- however, the ABA believes that s.207-158 should, in fact, generally not be triggered by the relevant overseas tax calculations. This is essentially on the basis that the manner in which the overseas jurisdictions generally calculate deductions for branches is on a notional basis and the anti-hybrid rules do not and were not intended to apply to such notional calculations. Furthermore, even if s.207-158 was triggered, the amount of the foreign income tax deductions in question are *de minimis* in the context of the industry's AT1 issuances;
- accordingly, given the significant ongoing complexity and uncertainty that the amended s.207-158 would entail, and the associated compliance burden for taxpayers and the ATO, the ABA submits that:
    - domestic AT1 issuances should be excepted from s.207-158;
    - the amendments and/or the accompanying explanatory memorandum (**EM**) should clarify that the provision is not triggered by notional calculations of the type discussed in the "Background" section below;
    - the provision should only be triggered if the foreign income tax deductions that can be identified exceed 10% of the total franked distributions on AT1 instruments in a given year; and
    - various other clarifying amendments should be made to the provisions (for instance, in relation to the ability of taxpayers to not claim deductions overseas and the inadvertent claiming of deductions).

Background

Overview

AT1 instruments form an important part of the major Australian banks' capital structures, and are a form of capital instrument familiar to retail and wholesale investors. AT1 instruments are equity interests for Australian tax purposes and it is typically intended that the distributions paid on AT1 instruments will be fully or partly franked.

As a result of amendments made at the same time as the introduction of Division 832, holders of equity interests will not be entitled to a gross-up and tax offset with respect to franking credits attached to a distribution if:

> "*all or part of the distribution gives rise to a foreign income tax deduction*"
>
> (ss.207-145(1)(db) and 207-158)

These amendments were a specific anti-avoidance measure introduced to counter so-called 'deductible/frankable' instruments, being capital instruments issued out of an offshore branch of a bank where the bank was able to claim an income tax deduction for the payments in the country where the branch was located, while the payments were also frankable for Australian tax purposes. This type of instrument was considered by the High Court in *Mills v. Commissioner of Taxation* [2012] HCA 51.

That these amendments were intended to apply to offshore issuances is evident from Example 2.1 in the OECD's Action 2: 2015 Final Report.

Recent discussions with ATO in relation to notional branch calculations

The application of s.207-158 has recently been discussed between the ATO and ABA members in the context of ATO class rulings being provided in relation to domestic AT1 issuances.

As noted above, pursuant to ss.207-145(1)(db) and 207-158, a gross-up and tax offset will not be available to the recipient of a franked distribution if all or part of the distribution "*gives rise to a foreign income tax deduction*". "Foreign income tax deduction" is, in turn, defined in s.832-120. Broadly, "an amount of a loss or outgoing" is a foreign income tax deduction if an entity is entitled to deduct "the

amount” in working out its tax base in the relevant tax period.

The ABA has recently discussed with the ATO how s.207-158 operates in the context of the taxable income calculations for certain overseas branches in their home jurisdictions.

A number of ABA members, in particular the largest Australian banks, operate through branches in a number of overseas jurisdictions. Typically, these branches will primarily undertake institutional banking activities, including lending and markets operations, and may have local treasury operations.

In particular, the operation of s.207-158 has been considered in relation to certain ABA members’ branches in the United Kingdom (**UK**) and Japan. Relevantly, both the UK and Japan have implemented, in their domestic tax legislation, a form of the ‘Authorised OECD Approach’ (**AOA**) to attributing profits to permanent establishments (**PEs**), and distributions on AT1 instruments can be treated as deductible in those jurisdictions (including as part of the notional branch calculations). Hong Kong has also released new guidance adopting a form of the AOA, starting to apply in 2020.

The ABA is not aware of any proposals by the Governments of the other jurisdictions in which its members have PEs to introduce the AOA in tax systems where distributions on AT1 instruments can be deductible. However, it is possible that further jurisdictions will choose to adopt the AOA in the future, or Australian banks could expand their operations into other jurisdictions that have adopted a form of the AOA.

The reason that it was thought necessary to consider the rules in the UK, Japan and Hong Kong is as a result of the manner in which those countries allocate capital to PEs for the purposes of calculating taxable income under the AOA. The basic premise of the AOA is that the profits attributable to a PE are those that the PE would have earned on an arm’s length basis if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the PE. The OECD provides guidance on how banks should apply the AOA, which broadly requires that a capital and funding structure be hypothesised for the PE of a bank and funding costs be assumed on an arm’s length basis.

The purpose of the capital allocation is to ensure that the branch is not able to claim tax deductions for funding costs over and above what it would be entitled to claim if it had been funded with appropriate amounts of capital having regard to the level of its ‘risk-weighted assets’.

The ABA submits that s.207-158 does not and was never intended to apply as a result of such tax calculations for overseas branches, merely because the relevant country has adopted a form of the AOA.

We have outlined below how the UK rules operate because we believe it is important that Treasury understand how relevant overseas rules operate and to set out why the ABA submits that such calculations do not (and should not from a policy perspective) trigger s.207-158. The UK branches of most of the major Australian banks are also orders of magnitude greater in size than their Japanese and Hong Kong branches, such that any of their material deductions relevant to s.207-158 would be in relation to the UK.

UK rules

The UK tax law contains rules setting out the basis on which the profits attributable to a UK PE of a non-resident company are to be determined. In particular, those rules provide that the profits to be attributed are those that the PE would make if it were:

- a separate entity in the UK;
- engaged in the same or similar activities;
- under the same conditions; and
- dealing wholly independently of the non-resident company.

That is, the UK adopts a form of the AOA. In arriving at those notional profits, certain assumptions are to be made, including that the PE has the equity and loan capital that it would have if it were a separate

UK regulated entity carrying out those activities, under those conditions. The law prohibits deductions for funding costs in arriving at those profits in excess of those which would have arisen on that assumption.

The purpose of the assumption regarding the PE's equity and loan capital is explained in UK HMRC guidance note INTM267705[2]:

> "*The new legislation does not require the actual allotment of capital to the UK PE. This remains, as now, a matter for the bank itself. But where there has in fact been a capital allotment based on the economic and regulatory requirements of the PE's business, any tax adjustment under the new legislation is likely to be relatively minor, taking into account that allotment.*
>
> *Where, however, the UK PE's business is not supported, or is inadequately supported by capital, the purpose of the legislation is to make an adjustment to the UK tax computation to align the taxable profits more closely with those that would be achieved by similar banking activities carried on by a UK bank in the same or similar circumstances.*"

Practically, the UK rules require a comparison between the actual capital position of the branch with the AOA hypothesised capital allocation to calculate any required adjustment amount. The hypothesised stand-alone capital position of the branch will take into account Common Equity Tier 1 capital, AT1 capital and Tier 2 capital, as applicable under the relevant Basel capital adequacy standards applying to banks.

As payments under AT1 capital (and Tier 2) instruments issued by UK headquartered and regulated banks are treated as deductible in the UK under UK domestic legislation, in undertaking the notional calculation to determine whether there is a tax adjustment in the UK, the calculation assumes that the branch would be similarly entitled to deductions referable to the amount of AT1 capital (and Tier 2) that is notionally allocated to it.

However, this is a notional calculation based on how much AT1 capital the PE would be expected to have if it were in fact a standalone bank.

In calculating the notional deductible amount available for AT1 capital, a bank may, as a practical matter, where alternative approaches are not available/appropriate, look at the bank's actual capital stack (including AT1 capital) and the margins payable on its AT1 instruments as a proxy for determining both the level of AT1 notionally attributed to the UK branch and the average cost of funding on AT1 securities. However, this is not a requirement of the UK legislation – the UK legislation requires arm's length costs and this is simply being used as a proxy.

For instance, an Australian bank may use the margins on its actual AT1 issuances to determine the appropriate margin that it would have to pay on a GBP issuance in the UK – e.g. the margin plus GBP Libor.

We submit that s.207-158 should not apply merely as a result of a bank using this type of practical proxy approach for the purposes of determining whether there is a required adjustment to its funding costs in the UK. None of the actual AT1 distributions payable by the bank on a domestic AT1 issuance are treated as deductible in the UK as a result of this notional calculation. This is a hypothesised calculation undertaken by reference to notional amounts of capital and at no stage are distributions paid on a domestic AT1 instrument (or an AT1 instrument issued through another non-UK branch) deductible in determining the UK tax liabilities of the UK branch. Therefore, we consider that in terms of s.207-158, no part of any distribution paid on the AT1 securities will "give rise to a foreign income tax deduction". In particular, a distribution paid on an AT1 security is not "an amount of a loss or outgoing" that the bank is entitled to deduct in the UK, because the UK calculations are notional/hypothetical calculations that are not based on the actual payment of AT1 distributions by the bank.[3]

[2] Available at https://www.gov.uk/hmrc-internal-manuals/international-manual/intm267705

[3] Obviously the position would be different and s.207-158 capable of applying if, for instance, an AT1 was issued through a UK branch (but failing s.215-10) and franked distributions paid were deducible in the UK.

Australian Banking Association

The notional nature of the calculation is reflected in the HMRC guidance materials. By way of example, INTM267706[4] which provides an overview of the steps states that:

> "*It should be noted that a required adjustment to funding costs is purely a computational one for tax purposes and has no effect on the way in which a UK permanent establishment conducts or funds it actual business.*"

That is, this notional calculation for the purposes of determining whether there is an adjustment to funding costs is not based on the actual capital that has been allocated by head office to a UK branch.

Furthermore, in relation to AT1 capital, INTM267773[5] states:

> "*Where it is accepted that a PE can be hypothesised as having innovative or hybrid Tier 1, then the amount of any such issue cannot exceed the amount that the company would be able to issue if it were a separate enterprise trading in the UK.*"

The notional nature of the calculation is reflected in the fact that it is possible for an amount of AT1 capital to be allocated to a UK branch even if the group has no AT1 capital on issue (because the home jurisdiction does not permit the issue of AT1 capital). INTM267776 states:

> "*There may be cases where the home state does not allow the issue of AT1 capital so there is none in the company, but the UK PE being treated as a standalone company in the UK would both satisfy the regulatory requirements for an issue of AT1 and would be of sufficient size to make such an AT1 issue. If this is the case, HMRC will accept, in principle that the UK may include an appropriate proportion of AT1 in its loan capital structure.*"

This is important as if the UK calculation would allow recognition of a deductible amount in respect of AT1 capital even if the bank had no such capital on issue then the calculation is clearly notional in nature. Further, if there is an actual AT1 instrument that has been issued by a UK branch, say a s.215-10 instrument, then those actual funding costs in the branch can be subject to adjustment under the notional calculation. This is consistent with the logic of the provisions which are designed to impute a notional capital stack for the PE based on a standalone comparable entity in the UK.

Notional calculations

As noted above, "foreign income tax deduction" is defined (in s.832-120) as, broadly, an amount of a loss or outgoing that an entity is entitled to deduct in working out its tax base under a law of a foreign country. Again, this test is framed by reference to whether the "loss or outgoing" is treated as deductible in the foreign country – i.e. the test is focused on whether the actual payment (the loss or outgoing) is deductible in the foreign country rather than whether there is a notional calculation which takes the type of instrument into account.

Further, although the EM to the hybrid mismatch rules in Division 832 stated that s.832-120 may include a situation where the amount is an element in the calculation of a net amount that is included in the tax base in the foreign country (see para 1.86), it is clear that the amount of the actual payment, loss or outgoing must be included in the calculation. That is not the case here – the UK calculation is undertaken on a notional or hypothesised basis and does not include actual payments, losses or outgoings of an Australian bank in respect of AT1 instruments. In this regard, the EM stated that:

> *"The hybrid mismatch rules in Division 832 apply if an entity (the payer) makes a payment to another entity (the recipient). The existence of a payment underpins the Division 832 hybrid mismatch rules. A payment involves the transfer of value from the payer to the recipient. It does not include a deemed or notional payment that is recognised solely for taxation purposes and that does not involve the creation of economic rights between the payer and the recipient."*
>
> (paragraph 1.36)

[4] Available at https://www.gov.uk/hmrc-internal-manuals/international-manual/intm267706
[5] Available at https://www.gov.uk/hmrc-internal-manuals/international-manual/intm267773

This principle that the hybrid provisions are focused on actual payments is also reflected in the OECD materials which the relevant sections were enacted to implement. In this regard, the OECD Action 2: Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements states in reference to the term "deduction":

> "*Under the hybrid mismatch rules a deduction must arise in respect of a "payment". Therefore the starting point in applying the mismatch rules is to look for the legal basis for the deduction to determine whether the deduction relates to actual expenditure or transfer of value rather than it being a purely notional amount for tax purposes.*"
>
> (paragraph 391)

Section 207-158 refers to "a distribution" because it links back to s.207-145, which applies to franked distributions.

It is clear under the legislation that "a distribution" is an actual payment on the instrument. The definition of "foreign income tax deduction" in s.832-120 is based on whether an entity is entitled to deduct "an amount of a loss or outgoing". The natural reading of the provision is therefore that it applies where a company pays a distribution and they are entitled to a deduction for all or part of the amount of money (the outgoing) that they have paid.

The "gives rise" terminology in s.207-158 is inherited from Division 832, which refers throughout to whether a payment "gives rise" to a foreign tax deduction. As is the case in Division 832, when s.207-158 refers to whether a distribution "gives rise" to a foreign income tax deduction, this stipulates a condition that it be the payment of that amount of money that means there is *an amount of a loss or outgoing* (that is deductible in a foreign country). "Gives rise" is not merely referring to whether there is some causative link or other connection between a distribution and some other amount of a loss or outgoing that is a deductible (actually or notionally) in a foreign country.

The ABA acknowledges that if there are overseas rules (for instance, Hong Kong and Japan) that may operate differently to the UK rules then they would need to be considered separately.

As reflected in the analysis above, the ABA considers that these notional UK branch calculations should not trigger the application of the current or proposed amended versions of s.207-158. We consider that this is the outcome under the natural reading of the provision, both alone and in the context of the broader hybrid mismatch provisions, and is consistent with the underlying purpose of s.207-158 and OECD principles (in particular, see OECD Action Item 2 Recommendation 2.1). Any alternate interpretation of s.207-158 and thereby the Division 832 hybrid rules would lead to an unintended operation of the rules.

Addressing the gateway test in s.207-158

Unfortunately, the draft legislation does not provide any further clarity on the gateway condition for the provision to apply, such as in relation to the issues discussed above. Rather, the draft legislation offers a practical solution *if* there is a problem in relation to a jurisdiction.

The explanatory material when s.207-158 was introduced also contained very limited guidance as to how it operates. At the least, if Treasury agrees (which we hope, for the reasons considered above, is non-controversial) that the provisions were not intended to apply to notional calculations then we request that this position is made clear in the amendments and/or the accompanying EM. This clarification would be extremely useful for issuers, investors and the ATO as it would significantly reduce the compliance burden and potential uncertainty that may otherwise follow.

In this regard, we note that the EM to the ED states that:

> "*An amount that reflects all or part of the distribution will give rise to a foreign income tax deduction if an entity is entitled to deduct the amount in working out the tax base for a foreign tax period under the law of a foreign country dealing with foreign income tax (section 830-120).*"
>
> (paragraph 1.79)

We consider that this is not an entirely accurate description of the provisions, and unintentionally creates even more uncertainty. As discussed in the “Background” section above, the provisions require that the issuer is entitled to a foreign deduction for all or part of the money that they actually pay – not merely that there is a deduction for an “amount that reflects” all or part of a distribution, which could be taken to cover the type of notional calculations discussed above.

The ABA agrees that the legislation should contain the practical fallback solution in light of the extremely punitive effect of the provision on massive numbers of taxpayer investors if the rule was ever inadvertently or unknowingly triggered.

However, the fundamental issue is that the gateway condition for the provision to apply should in our view be clarified and specific exclusions included where appropriate so that, as is expected under a self-assessment regime, taxpayers can assess their arrangements with a sufficient level of certainty, even if so as to reasonably and faithfully confirm to the Commissioner that they undertake not to claim any relevant foreign income tax deductions.

Importantly, although the provision may be most relevant to the large Australian banks because of their overseas branches, in practice assuming that large banks are lodging s.207-158 notifications with the Commissioner, it may be that all banks and insurers that issue AT1 instruments will practically be compelled to lodge s.207-158 notifications with the Commissioner in order to provide investors with sufficient certainty (unless the gateway condition in s.207-158 is more clearly defined so as to facilitate the Commissioner issuing class rulings that rule on the provision rather than assume there are no foreign tax deductions).

Exclusion for domestic issuances

We consider that there are very strong reasons why s.207-158 should not apply to domestic issuances.

Before considering these reasons in detail, we note that the holders of domestic AT1 securities are typically Australian retail investors (i.e. “mums and dads”). Furthermore, as Treasury is aware, the effect of s.207-158 is to deny an entitlement to all franking credits and tax offsets in relation to distributions on the infringing instrument, even if the foreign deduction is only a small fraction of such distributions. As such, the provision is a very severe anti-avoidance provision which we submit was intended to apply to a specific fact pattern that the Government decided was egregious (the offshore ‘deductible/frankable’ issuances). We do not consider that it would be appropriate for such a severe anti-avoidance provision to inadvertently apply (and have such severe consequences for “mums and dads”) because of the type of notional branch calculation discussed in the “Background” section above – especially when the quantum of overseas deductions is relatively *de minimis* in the context of the industry’s AT1 issuances and the link between the domestic issuance and the overseas deductions is, at best, marginal. The ABA does not consider that such a penal anti-avoidance provision was intended to apply or indeed should apply in such circumstances.

In further detail, we consider that there are a number of compelling reasons why s.207-158 should not apply to domestic AT1 issuances. We have summarised these below:

- **Domestic issuances were not the intended target of s.207-158.** As discussed above, it is clear that the intended target of s.207-158 was offshore ‘deductible/frankable’ instruments, and that domestic AT1 issuances were not generally intended to be caught.
- **Section 207-158 does not in fact apply in respect of all or most relevant overseas jurisdictions but creates considerable uncertainty.** For the reasons discussed in the “Background” section above, we submit that s.207-158 does not apply in relation to the type of notional UK branch calculations discussed above. Furthermore, it is not clear whether s.207-158 may apply in relation to Hong Kong or Japanese branch calculations. Where there is such a limited potential application of the rule, it seems inappropriate to impose such significant uncertainty and disruption on the domestic AT1 market as a result of those types of overseas notional tax calculations. This is especially the case as the consequences of s.207-158 applying are borne by the holders of the instruments (typically, “mum and dad” retail investors) as it is

Australian Banking Association

they who would be denied franking credits and tax offsets.

- **No intention of issuers to generate hybrid mismatches.** There is no intention on the part of issuers of domestic AT1 instruments to generate deductions overseas in respect of the notional calculations in these jurisdictions. If Treasury has any integrity concerns about a blanket exception for domestic issuances, then these concerns should be clearly articulated and specifically addressed through carve-outs to a general exception for domestic issuances.
- ***De minimis* quantum of foreign deductions.** The quantum of potential foreign income deductions as a result of these notional calculations in relation to domestic AT1 instruments is *de minimis* in the context of the industry's AT1 issuances.
- **Significant technical and practical problems through interplay with foreign laws**. In the context of a 'deductible/frankable' instrument where actual distributions on AT1 instruments are giving rise to deductions in the other jurisdiction and hence s.207-158 would be triggered, identifying the relevant foreign income tax deductions is relatively straightforward.

  In contrast, in the context of notional/hypothesised calculations of the type discussed in relation to the UK, it is extremely difficult to determine what, if any, amounts should be treated as the relevant foreign income tax deductions. The ABA submits that s.207-158 should not in fact apply in respect of such notional calculations, but if a different view was taken then the provision will be extremely difficult to comply with and to administer in practice.

  Further, the proposed amended s.207-158 contains a carve-out for where the issuer notifies the Commissioner that it "…*will not claim any amount of a *foreign income tax deduction to which distributions on the interest give rise*". There is considerable uncertainty as to the ability of an issuer to not "claim" a deduction in a foreign jurisdiction. Under Australian tax law, for instance, there is no technical ability for a taxpayer to not claim a deduction, an amount is simply deductible or non-deductible.

  There is also the possibility of an issuer inadvertently claiming deductions overseas. This issue has not been addressed in the current draft legislation, and is discussed further below.
- **Significant compliance burden.** Complying with s.207-158 where its operation is not clearly based on the deductibility of actual distributions in an overseas jurisdiction will impose a significant compliance burden on both issuers and the ATO, requiring ongoing examination of foreign jurisdictions' rules and the precise way the overseas branch calculations are done. For the reasons discussed above, the ABA submits that the provision should not be triggered merely as a result of the type of notional calculations discussed in this submission, and hence each branch and each branch calculation will need to be considered on a case-by-case basis. This would be despite the quantum of possible foreign income deductions being *de minimis* in the context of the industry's AT1 issuances and, as discussed above, s.207-158 operating in this fashion is contrary to OECD Action 2 principles which are based on actual payments/expenses producing deductions. In these circumstances we submit that there is no reasonable basis to impose such a compliance burden on issuers.

Additional amendments to s.207-158

The ABA also submits that the provision should be amended as follows.

- **Clarify that notional calculations such as in the UK do not trigger s.207-158.** As discussed in the "Background" section above, we submit that such calculations should not result in s.207-158 applying. However, given the extremely punitive consequences of the provision applying, and to reduce uncertainty for issuers and investors, we request that Treasury clarify this in the legislation itself (or related regulations) and/or through an example in the EM. For instance, the legislation could allow the Treasurer to declare that s.207-158 does not apply in relation to certain calculations or deductions in certain jurisdictions (such as the UK), similar to the current 'eligible designated concession income' rules.

- **Threshold percentage for s.207-158 to apply.** The amount of the deductions that banks may be entitled to in overseas jurisdictions in relation to notionally attributed AT1 instruments is small. Notwithstanding this, the potential consequences of the application of the rule are extremely severe (and will fall on the "mum and dad" retail investors). Having regard to this, together with the significant administrative burden that monitoring and complying with the proposed amendments will entail (i.e. including monitoring all branch jurisdictions, undertaking the calculations and monitoring changes in law throughout the world), we submit that it would be entirely appropriate to include a threshold that the quantum of the deductions must exceed for s.207-158 to apply.

  We submit that a reasonable threshold would be that foreign income tax deductions only result in s.207-158 applying to the extent they exceed 10% of the total franked distributions on AT1 instruments in a given year.

  If that threshold is breached, given the potential difficulties and uncertainties around being able to disclaim an entitlement to deductions overseas, a more practical approach would be to require an additional payment of tax in Australia – i.e. by including an additional amount in Australian assessable income equal to the amount by which the foreign income tax deductions exceed the 10% threshold.

  In our view, the introduction of such a threshold percentage for the provision to apply would be consistent with various parts of Division 832 that moderate the impact of the hybrid mismatch rules – e.g. the 3 year deferral threshold for the hybrid financial instrument rule and the dual inclusion income rules.

- **Ability to not claim a deduction in overseas jurisdictions.** As noted above, there is considerable uncertainty as to the ability of issuers to voluntarily not claim deductions overseas. As such, the provisions should make it clear that s.207-158 will not apply if an issuer is unable to not claim the relevant foreign income tax deductions. If such an amendment is not made then it will be impossible to ever provide certainty for the holders of the instruments – i.e. they will simply be denied all of the franking credits if this situation ever arose. This would be an entirely unsatisfactory outcome and would have the potential to cause significant disruption to the AT1 market (as issuers are required to disclose any risks, including tax risks, to investors in the relevant offering document or prospectus). Again, a practical approach to address this would be to include in Australian assessable income an amount equal to the relevant overseas deductions that the issuer is unable to not claim.

- **Inadvertent claiming of deductions overseas.** Given the complexity and uncertainty surrounding relevant overseas rules, and timing issues, there is the possibility that an issuer inadvertently recognises an amount overseas that could be regarded as triggering s.207-158. For instance, with respect to timing, an issuer could provide a notification to the Commissioner under s.207-158, but not be required to lodge a foreign tax return until, say, 18 months later, creating significant operational risk that a deduction is inadvertently claimed.

  The current exposure draft does not address the possibility of inadvertently claiming deductions overseas after the requisite s.207-158 notice has been provided to the Commissioner. Again, the consequences of such an inadvertent breach would be felt by the investors who would be denied franking credits in relation to all distributions on the securities.

  Technically, it seems that as currently drafted such an inadvertent claiming of a deduction would not prevent the exception in draft proposed s.207-158(2) from applying. However, assuming that this is not how the provision is intended to apply, we submit that the provision should include a remedy mechanism for inadvertently claiming deductions overseas.

  There may be technical and practical difficulties with such a mechanism requiring the issuer to amend overseas tax returns (i.e. to reverse deductions previously claimed), especially given the uncertainty surrounding the ability to voluntarily not claim a deduction overseas to which the issuer is entitled. Again, we submit that a more practical approach would be to include in Australian assessable income an amount equal to the relevant deduction inadvertently claimed

Australian Banking Association

overseas.

- **Legal form share AT1 instruments.** The proposed exception in s.207-158(2) would currently only apply in relation to "non-share equity interests". Although in recent times AT1 instruments have typically been legal form debt instruments, this is not always the case. The ABA submits that the exception should be capable of applying in relation to any "equity interest" that satisfies the conditions in draft amended s.207-158(2).
- **Non-operating holding companies.** A number of Australian APRA-regulated entities have non-operating holding company (**NOHC**) structures. Currently, the draft amended ss.207-158(2) to (4) apply to interests issued by an ADI or an insurance company. These provisions should also cover scenarios where the relevant interest is issued by a NOHC of such an entity, or by such an entity where it is ultimately held by a NOHC as the head company of its tax consolidated group or MEC group. As discussed below, we note that the EM to the ED already contemplates the possibility that the relevant AT1 instrument could be issued by a subsidiary of an ADI or an insurance company, although this is not reflected in the legislation.
- **Relevant entity entitled to foreign income tax deductions.** In the context of AT1 instruments being issued by a subsidiary of an ADI or an insurance company, the EM to the ED refers to the notification to the Commissioner confirming that no foreign income tax deductions will be claimed by the ADI or the insurance company or *any other entity*. This should be confined to the other entity that issued the equity interest if it was not issued by the ADI or the insurance company. We assume that this is what is intended, and simply referring to *any other entity* would mean the confirmation is in relation to any entity in the world.

As noted above, the ABA submits that in certain scenarios (e.g. inadvertently claiming foreign deductions or not being able to voluntarily disclaim the entitlement to foreign deductions) a practical/reasonable approach would be to include an additional amount in Australian assessable income. The ABA also submits that this mechanism could be adopted more generally in s.207-158 – that is, to the extent that there would be relevant foreign deductions exceeding the 10% threshold, the excess would be included in the issuer's Australian assessable income unless the issuer does not claim those foreign income tax deductions. We consider that this approach would still be consistent with the underlying purpose of s.207-158 in the context of AT1 instruments and OECD Recommendation 2.1 more generally.

Transitional arrangements

The ABA understands that the intention is that these amendments will not affect the existing transitional/grandfathering rules for s.207-158. Although this seems to be the effect of the current draft ED, it would be helpful if this could be confirmed in the EM. If this is not the intention, the ABA would like to discuss this with Treasury.

Other funding issues

As discussed above, s.207-158 raises issues around the treatment of amounts included in notional overseas tax calculations and whether this should be treated as giving rise to a foreign income tax deduction.

Although not related to s.207-158, we note that similar issues may arise in the context of certain overseas funding arrangements for a number of Australian banks.

By way of example, assume the following facts and tax treatment:

- An Australian bank issues $1bn of notes through a US branch to offshore investors. US branch has other funding arrangements and assets.
- US branch then lends $1bn to its Australian head office on terms matching those of the external notes. Head office uses the funds in its pool of funds in carrying on its general banking business in Australia.

- Broadly, for US tax purposes:
  - the inter-branch loan is disregarded (and hence US branch does not recognise any interest income in connection with loan);
  - US branch recognises taxable income from its third party assets; and
  - rather than being entitled to an interest deduction for the interest paid under the $1bn funding, in calculating branch profits taxable in the US, US branch is entitled to recognise deductions for interest expenses in relation to a notional amount of funding supporting its third party assets.
- For Australian tax purposes, there are two possible treatments that should produce the same outcome:
  - TR 2005/11 para 47 indicates that the inter-branch loan would be recognised as a proxy for allocating to US branch part of the head office income from the use of the funds in its ordinary business;
  - Head office recognises (i) the inter-branch loan as a proxy for recognising the external interest expense on notes (hence arguably effectively claiming a deduction); and (ii) assessable income from the use of funds lent from US branch, which it uses for ordinary business purposes.

We consider that the deducting hybrid provisions in Subdivision 832-G are the potentially relevant provisions in this context. Broadly, those provisions can apply where a payment gives rise to a "deduction/deduction" mismatch. In the example above, the interest payments on the external notes are the relevant payments.

For Australian tax purposes, where the loan from US branch to head office is recognised as a proxy for allocating the external interest expense on the US notes to head office, in our view the hybrid provisions should not apply because the US does not allow a deduction in relation to those interest payments (which are not supporting its third party assets). Rather, the US allows a deduction for an amount of funding that the US considers should be regarded as funding the US branch (calculated by reference to the third party assets of the US branch).

Alternatively, if the loan from US branch to head office is recognised as a proxy for allocating head office income to US branch then it is not clear that there is a deduction for the bank in Australia. Even if there was taken to be a deduction, in our view the hybrid provisions should not apply for the same reason – the deduction would be in relation to the external interest expense on the US notes and the US does not allow a deduction in relation to those interest payments.

This is just one example of the types of fact patterns that arise in relation to notional overseas tax calculations which, although Division 832 may not apply (consistent with OECD principles), highlight that the key principles could be expressed more clearly.

It may be that this can be sufficiently addressed through ATO interpretative guidance on these issues, but in the absence of that interpretative guidance we submit that the legislation should be amended to clarify the position.

However, this is a separate issue to the operation of s.207-158 and does not affect any of the other proposed amendments contained in the ED. Accordingly, we propose that Treasury proceed with the legislative amendments to address s.207-158 (and the other changes in the ED) and that the ABA has subsequent discussions with the ATO and Treasury in relation providing more helpful guidance/legislative clarity in relation to these other issues.

Australian Banking Association

Conclusion

Thank you for the opportunity to provide comments on the exposure draft legislation. We would be happy to meet with Treasury to discuss any of the matters raised in this submission.

Yours sincerely

Signed by

Essam Husaini
Associate Director, Policy
02 8298 0424
Essam.Husaini@ausbanking.org.au