



KPMG Australia submission

Miscellaneous amendments to Treasury portfolio laws: Amendments to *Income Tax Assessment Act 1936*

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Executive Summary

KPMG Australia (“KPMG”) appreciates the opportunity to provide comments on the proposed miscellaneous amendments to Treasury portfolio laws, released by Treasury in Exposure Draft (ED) form on 24 September 2021.

Our comments in this submission relate to the proposed amendments to the *Income Tax Assessment Act 1936* (“ITAA 36”) as a consequence of the cessation of the London Interbank Overnight Rate (“LIBOR”).

In Section 1 of this submission, we set out the background of taxpayers’ experience with the current law. Section 2 includes our comments on the ED and Section 3 sets out our proposed alternative solution.

Our principal comments are as follows:

- The LIBOR cap provisions in Part IIIB of ITAA 36 have, like LIBOR itself, outlived their usefulness. Treasury should adopt a different approach for dealing with the impact of the cessation of LIBOR on those provisions.
- The work being done by regulators and financial institutions globally demonstrates that there is not a simple, economically equivalent replacement benchmark rate for LIBOR. The financial crises of the past decade or so have demonstrated that not all banks’ credit is of the same quality. The idea that there is a benchmark rate at which banks borrow and lend with each other is no longer realistic.
- The government should remove the LIBOR cap, and any excessive amount of interest recorded in the accounting records of the branch should be subject to adjustment (as it is today) by operation of the transfer pricing provisions in Subdivision 815-B ITAA 97 and the thin capitalization provisions. Our proposed drafting of the changes required to give effect to this solution is set out at paragraph 3.2 below. This approach would be an effective way, without any practical cost to the revenue, of avoiding the compliance costs, both for the Commissioner and taxpayers, associated with the continuation of the capping regime.
- Requiring the Commissioner to determine and monitor qualified rates across the multitude of currencies and tenors would require significant administrative effort on the part of the Australian Taxation Office (“ATO”). Further, if the Commissioner set rates that were not consistent with the borrowing costs actually incurred by the relevant taxpayers, they would simply elect out of Part IIIB. Having taxpayers operating outside Part IIIB would increase



transfer pricing compliance costs for taxpayers and for the ATO in its monitoring activities.

- Based on the 2019 Tax Statistics released by the ATO, only 26 taxpayers in the 2019 income year disclosed participating in the Part IIIB regime on their 2019 income tax return. It is our understanding that this number has decreased since that time. It is in this context that the cost of maintaining the qualified rates should be judged.
- The removal of the capping mechanism would increase the withholding tax revenue collected. Currently, irrespective of whether taxpayers are subject to Part IIIB or not, the LIBOR capping mechanism applies to the amount of notional interest that is subject to withholding tax.



KPMG detailed comments

1 Background to the current provisions

- 1.1. Taxpayers can elect that Part IIIB ITAA 36 should not apply. The effect of the election is that transactions between the Australian branch and the bank (either head office or branches in other non-head office jurisdictions) are not recognised for Australian tax purposes.
- 1.2. Instead, there is a requirement to attribute an arm's length amount of profit to the branch. However, in Taxation Ruling TR2005/11 *Income tax: branch funding for multinational banks* the ATO states at paragraph 9: "*We accept entries in a bank's books of accounts that reflect arm's length interest charges on intra-branch funds transfers as a means of determining an allocation or attribution of the bank's income, expense or profit in accordance with Australia's PE attribution rules.*"
- 1.3. Therefore, provided that the interest expense recorded in the branch's accounts reflects an arm's length rate, there is in practice no significant difference in the way the notional interest expenses are determined, whether Part IIIB applies or not.
- 1.4. A taxpayer can only elect to disregard Part IIIB where it results in the taxpayer's taxable income being less (or its tax loss being greater) than would have been the case if Part IIIB had applied. The main reason for taxpayers electing to disregard Part IIIB is the denial of interest deductions as a result of the current LIBOR cap.
- 1.5. The major concern about the LIBOR cap mechanism is how it operates in relation to longer term notional borrowings used to manage the liquidity position of branches.
- 1.6. For example, the notional interest on a 3-year floating rate borrowing would typically reset every 30 or 90 days and the applicable LIBOR would be the 30 or 90 day LIBOR for the relevant currency. The requirement in Part IIIB to use the 30 or 90 day LIBOR does not align with the actual arm's length rate for such a borrowing, which would necessarily include a term premium.
- 1.7. A taxpayer who applies Part IIIB, and one who elects to disregard it, are both subject to the operation of the transfer pricing rules in Division 815 ITAA 97. For taxpayers who apply Part IIIB, subdivision 815-B is relevant to notional transactions (borrowing, derivatives and foreign exchange), while subdivision 815-C is relevant for all other allocations. For other taxpayers, only subdivision 815-C is relevant in terms of attribution of income and expenses to the Australian branch.
- 1.8. Part IIIB imposes withholding tax ("WHT") on the notional interest that the Australian branch is taken to have paid. This obligation to pay WHT arises



irrespective of whether the taxpayer applies Part IIIB or not. In both cases the LIBOR capping provisions limit the amount of interest that is subject to WHT. Therefore, where a taxpayer elects to disregard Part IIIB it may be able to claim a deduction for interest in excess of the LIBOR capped amount, while the LIBOR cap limits the WHT to the capped interest amount.

2 The government's proposed amendments

Compliance and administrative costs

- 2.1. The exposure draft ("ED") places the obligation on the ATO to determine an appropriate qualified rate (or a method of determining such a rate). The ATO experienced difficulty in attempting to do so when the AUD LIBOR ceased to be quoted. The ATO consequently adopted an administrative approach in relation to AUD LIBOR.
- 2.2. The administrative approach required the ATO and industry representatives to spend significant effort to determine the necessary appropriate adjustments to the BBSW rates. The cost of the obligation on the ATO to set and then continue to monitor the reasonableness and appropriateness of the qualified rates should not be underestimated.
- 2.3. By way of example, since the administrative approach for AUD LIBOR was introduced there has not been any review undertaken to determine whether the adjustments to the BBSW rates remain appropriate.
- 2.4. For taxpayers who have elected to disregard Part IIIB, the retention of the interest rate capping arrangements brings additional compliance effort and cost. Taxpayers who have elected to disregard Part IIIB are nonetheless required to disclose in their International Dealings Schedule the amount of notional interest taken to have been paid under Section 160ZZZA (which is impacted by the qualified rate rules).
- 2.5. There would be no reasonable basis for requiring taxpayers to calculate and apply the qualified rates when they are not relevant in determining the taxable income of the taxpayer.

Technical concerns

- 2.6. The ED contemplates there being one single rate of interest determined (or a manner of working out one single rate of interest) for any given currency at a particular point in time.
- 2.7. Proposed paragraph 160ZZZA(3)(a) states: *a reference to **the qualified rate**, in relation to a particular time, is a reference to **the rate of interest applicable at that time**, as determined for the particular currency under an instrument made under subsection (4)*; (emphasis added).
- 2.8. Proposed subsection 160ZZZA(4) states: *The Commissioner may, by legislative instrument, determine **a rate of interest**, or a manner of working out a rate of interest, **for a currency***. (emphasis added).

- 2.9. This drafting appears to restrict the ability of the Commissioner to determine more than one rate of interest for a particular currency at a particular time. It is not clear whether the “manner of working out a rate” allows for different rates to be determined depending on the tenor of the loan.
- 2.10. LIBOR is currently quoted for several tenors in each currency and accordingly the ED should require the legislative instrument to set out rates (or a manner of working out rates) for different tenors in each currency. This would then be consistent with existing (and retained) drafting in subsection 160ZZZA(2) which refers to the qualified rate for borrowings in the currency “for a term, the number of days that most nearly approximates the days in the period.”
- 2.11. The explanatory material references the Secured Overnight Financing Rate for USD. This is an overnight rate only. It is not a suitable replacement for the USD LIBOR which is currently quoted for overnight, 1 week, 2 week, 1 month, 2 month, 3 month, 6 month and 12 month borrowing terms.
- 2.12. On 15 October 2021 the 12-month USD LIBOR was 0.27963% while the overnight USD LIBOR rate was 0.07113%. The 12-month USD LIBOR was nearly four times greater than the overnight rate. On the same date, the Secured Overnight Financing Rate for USD was 0.05%.
- 2.13. We recommend that subsection 160ZZZA(4) require the Commissioner to determine rates of interest for specified periods in respect of particular currencies. However, we acknowledge that the above example rates show the complexity associated with the determination of appropriate qualified rates for different tenors.
- 2.14. The ED does not make clear the consequences of borrowing in a currency for which a qualified rate has not been determined. The ATO has said:¹ *In the absence of a LIBOR rate we expect taxpayers to determine an appropriate proxy for the purposes of Part IIIB. Where a proxy has been used for a particular currency, then we would also expect that the taxpayers maintain supporting documentation that explains and substantiates the appropriateness of the proxy.*
- 2.15. Such an approach should not be sustainable where it is within the power of the Commissioner to determine the qualified rates. In the absence of a qualified rate the amendments to the law should make it clear there is to be no adjustment to the interest recorded in the accounting records of the branch.
- 2.16. Neither the ED nor the explanatory material provide guidance to the Commissioner on the matters to be taken into account when setting the

¹ Letter from Rebecca Saint, Deputy Commissioner of Taxation to Australian Financial Markets Association dated 1 April 2021 headed Justified Trust Top 1000 Program, Banking and Finance: Key Observations – Income Tax



qualified rate. There should be a clear articulation of the principles to be applied in determining qualified rates.

2.17. As our recommendation is that the capping mechanism should be removed, we have not sought to set out what these principles should be.

3 KPMG's proposed approach

- 3.1. The government should repeal the LIBOR capping mechanism. There should be repeal of existing section 160ZZZA and substitution with the text in paragraphs 3.2 below.
- 3.2. *(1) Subsection (2) applies where, under section 160ZZZ, an Australian branch of a foreign bank is taken, for the purposes of this Act, to have borrowed an amount (the notional borrowing) in a particular currency from that bank.*

(2) At any time when, in respect of the notional borrowing, an amount (the notional amount of interest) is entered in the branch's accounting records as interest for a period fixed by the bank, interest is taken, for the purposes of this Act, to be incurred by the branch, paid by the branch to the bank, and derived by the bank, in respect of the notional borrowing. The notional amount of interest for the purposes of this Act is the amount of interest so taken to be paid.
- 3.3. The above restates the relevant element of the existing subsection 160ZZZA(1). The remainder of the provisions would not be required.
- 3.4. A consequence of this approach would be that the notional interest deductible under section 160ZZZA would be limited to the arm's length amount of interest, by way of the operation of subdivision 815-B. This includes both the requirement for the notional borrowings to be subject to arm's length conditions as well as the interest charged being no more than an arm's length amount. This approach enables taxpayers to have regard to the tenor of the notional borrowing when determining the arm's length interest rate.
- 3.5. Removal of the interest capping mechanism would not result in taxpayers claiming material additional interest deductions. To the extent that the interest rate capping mechanism would otherwise result in a material disallowance of interest deductions in respect of notional borrowings, taxpayers would elect for Part IIIB not to apply. As a result they would be entitled to claim arm's length interest amounts as contemplated by our proposed approach.
- 3.6. Taxpayers who have previously elected to disregard Part IIIB due to the denial of interest deductions may decide to reapply the regime (the election occurs on a year-by-year basis). This would provide greater certainty in relation to the treatment of notional derivative and notional foreign exchange transactions for these taxpayers.
- 3.7. The amount of WHT payable on notional interest amounts would increase because the 5% WHT payable on the notional interest expense would not be limited by the interest rate capping mechanism.



- 3.8. Administrative costs would be reduced for the Commissioner in terms of not needing to determine and monitor qualified rates across a portfolio of currencies and tenors.
- 3.9. Taxpayers would benefit in terms of being able to apply Part IIIB and get greater certainty over the treatment of notional derivatives and notional foreign exchange transactions.
- 3.10. Taxpayers who have elected to disregard Part IIIB would benefit in terms of ceasing to undertake calculations of the impact of the capping rules for the purposes of income tax return disclosures and WHT calculations.

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