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James Campbell

Director,
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Dear James,

ATO Discussion Paper - Hybrid Mismatch Rules and Regulatory Capital

We refer to the ATO discussion paper entitled "Application of the hybrid mismatch rules to regulatory capital" (the **Discussion Paper**).

On behalf of the Australian Banking Association (ABA) we have set out a number of comments on the Discussion Paper in sections 2 and 3 below.

General

Deduction v entitlement to deduction

As reflected in paragraph 8 of the Discussion Paper, s.15-80(1) provides that:

"If section 207-158 would, apart from subsection 207-158(2), apply to a *franked distribution, then an amount equal to the *foreign income tax deduction referred to in subsection (1) of that section is included in the assessable income of the entity that made the distribution for the income year mentioned in subsection (2) of this section."

In paragraph 9 of the Discussion Paper, the ATO sets out its view that the test whether there is a "foreign income deduction" should be determined on an entitlement basis – i.e. if the taxpayer is "entitled" to a foreign income tax deduction then the test in s.15-80(1) will be satisfied (regardless of whether the taxpayer claims such a deduction).

We disagree with this interpretation. Rather, we consider that the test asks whether the taxpayer has actually recognised a foreign income tax deduction (rather than whether a taxpayer is entitled to recognise such a deduction).

We consider that this interpretation is consistent with the natural reading of both (i) s.15-80(1) which refers to "the" foreign income tax deduction, and (ii) s.207-158(1) which asks whether all or part of a distribution "gives rise" to a foreign income tax deduction. This is particularly the case in a situation like this where any "deductions" that are potentially recognised in the calculation of the tax position of a bank's overseas permanent establishment (PE) are being done on a notional basis by reference to a notional capital position that the PE is assumed to have (i.e. in order to effectively replicate the capital position that the PE would have if it was a stand-alone taxpayer in that jurisdiction).

We have not gone on to consider this point in further detail in this paper as we recognise that the approach that is being put forward by the ATO is an administrative compliance approach and is not determinative of the correct legal position. This position is recognised by the ATO in the Discussion Paper which notes that taxpayers that accept the compliance approach put forward by the ATO will not be regarded as conceding on this technical point (see paragraph 10).

Further general comments

Before going on to comment on the proposed methodology put forward by the ATO in the Discussion Paper (see section 3 below), we note the following other points :

Paragraphs 3 and 8 suggest that retaining the imputation benefits on AT1 distributions is dependent on an amount being included in assessable income under s.15-80(1). This is not correct as s.207-158(2) operates to ensure that imputation benefits are maintained (if the conditions in s.207-158(2) are satisfied). The consequence of not including an amount in assessable income under s.15-80(1) relates purely to that non-inclusion – i.e. the ATO could issue an amended assessment to a bank to require it to include the relevant amounts in its assessable income under s.15-80(1). Paragraphs 3 and 8 should be amended to reflect this.

Paragraph 19 should be amended to reflect the ATO's views on 'entitlement' as reflected in paragraph 9 of the Discussion Paper. We suggest that this change is made as otherwise paragraph 19 could be read as simply looking at the deductions claimed/recognised in the relevant overseas jurisdiction (rather than referring to an entitlement to a deduction). This appears to be the natural reading of the paragraph which refers to the "actual" amount of deductions "claimed".

Australian tax comments

Deduction for AT1 v deduction for AT1 in PE tax calculation

The Discussion Paper identifies the offshore jurisdictions in which Australian banks may operate through PEs.

The Discussion Paper then looks to identify the jurisdictions in which deductions may be available for distributions paid on AT1 instruments.

In our view, the question that should be answered is whether in the relevant jurisdiction (where a bank operates through a PE) the PE is entitled to recognise a tax deduction in relation to distributions paid on AT1 instruments <u>that are issued out of its head office in Australia</u>.

The test should <u>not</u> be focussed on whether the relevant jurisdiction allows deductions generally for distributions paid on AT1 instruments when issued in that jurisdiction (for instance, when issued by the PE).

This position can be illustrated by consideration of the position in New Zealand. In this regard:

- New Zealand allows taxpayers to recognise distributions paid on AT1 instruments as deductible; and
- consistent with this principle, if a New Zealand PE of an Australian bank issues an AT1 instrument then the distributions that are paid by the New Zealand PE should be deductible in New Zealand (subject to satisfaction of New Zealand's tax rules).

However, it does not follow from this that when a New Zealand PE of an Australian bank (that has not issued any AT1 instruments through that New Zealand PE) undertakes its New Zealand tax calculations, it is entitled to recognise (whether on an actual or notional basis) deductions in relation to distributions on AT1 instruments issued out of its head office in Australia. Indeed, we understand that this is not the case and no such deductions are available in New Zealand (see comments below).

Offshore Jurisdictions

The Discussion Paper identifies 6 main jurisdictions in which Australian banks operate through PEs, together with a further 19 jurisdictions where the banks may operate (albeit with very limited activities and assets).

Although the banks have not undertaken detailed due diligence on the other 19 jurisdictions, we note that the banks are not aware of any entitlement in any of those 19 jurisdictions for PEs of Australian banks to claim tax deductions (whether actual or notional) in relation to distributions paid on AT1 instruments issued by an Australian bank through its head office.

In relation to the other 6 jurisdictions, we note as follows:

United States, New Zealand and Singapore

In each of these jurisdictions, we understand that the relevant jurisdiction does not allow a PE of an Australian bank to claim any tax deductions (whether actual or notional) in relation to distributions paid on AT1 instruments issued by an Australian bank through its head office.

In relation to the US, this position is consistent with the ATO's understanding – as reflected in the Discussion Paper.

In relation to New Zealand, one of the banks has separately provided the ATO with an advice provided by their New Zealand tax adviser which confirms that no such tax deductions are available in New Zealand.

Further analysis in relation to the position in Singapore will be provided in due course.

Japan

We understand that Japan does allow a Japanese PE of an Australian bank to claim tax deductions in relation to distributions paid on AT1 instruments issued by an Australian bank through its head office.

United Kingdom

In relation to the UK, any "deductions" that are potentially recognised in the calculation of the tax position of the UK PE[1] (in the UK 'CATA' calculation) are recognised on a notional basis by reference to a notional capital position that the PE is assumed to have (i.e. in order to effectively replicate the capital position that the PE would have if it was a stand-alone taxpayer in that jurisdiction).

In the view of the banks, such potential notional tax deductions should not be treated as foreign income tax deductions for the purposes of the hybrid rules (including s.207-158 and s.15-80) – this is on the basis that the calculations are notional and include instruments not subject to s.207-158 (e.g. unfrankable instruments) as part of determining the amount of notional tax deduction available to the UK PE. As such, the UK CATA calculation does not have sufficient nexus or link to the distributions paid on the AT1 instruments by the bank in Australia.

We have not gone on to consider this position in any further detail, as the banks are prepared to accept, for the purposes of adopting a compliance approach to the application of s.15-80, that such deductions can be recognised for the purposes of the proposed methodology set out in the Discussion Paper.

Hong Kong

Although Hong Kong performs a similar 'CATA' calculation to the UK, we understand that there are differences between the positions in the UK and Hong Kong. In this regard (as discussed in further detail below) although the Hong Kong calculation requires a notional capital/debt stack to be calculated for a PE, the ability of the PE to claim deductions in relation to loan capital (including AT1) notionally recognised under that notional capital/debt stack, is determined by reference to the terms of the instruments that the head office and the PE have in existence.

As we understand that the terms of the AT1 instruments that the Australian banks have in existence (and which are subject to s.207-158) do not satisfy the tests in Hong Kong to be treated as debt, we understand that this means that the PE of an Australian bank is unable to recognise deductions on these AT1 securities in Hong Kong under the CATA calculation. This is discussed in further detail below.

[1] We note that some of the Australian banks do not claim any deductions in relation to notional AT1 instruments in their UK CATA calculations.

Following changes made in Hong Kong in 2016, distributions on AT1 instruments may be deductible in Hong Kong. This position is summarised in 'DIPN 53 Tax Treatment of Regulatory Capital Securities' – in this regard, paragraph 10 summarises that:

"The 2016 Amendment Ordinance and the 2019 Amendment Ordinance provide that a RCS is to be treated as a debt security. Generally, any payments under a RCS which are not repayments of principal are to be treated as interest for both deduction and taxation purposes. These include coupon payments, premium paid and discount given."

In order for distributions on AT1 instruments to be deductible in Hong Kong, the AT1 instrument has to qualify as a 'regulatory capital security' in Hong Kong. In this regard, the definition of a regulatory capital security or 'RCS' is set out in article 17A of the Hong Kong Inland Revenue Ordinance. Although an 'Additional Tier 1 capital instrument' will, prima facie, qualify as an RCS, this is subject to article 17A(2) which provides that regulatory capital security does not include:

"any debt instrument the terms and conditions of which provide for the issuer of the instrument converting, or having the option to convert, the instrument into a Common Equity Tier 1 capital of the issuer …"

We understand that the AT1 instruments issued by Australian banks which are subject to s.207-158 should not qualify as RCSs as these AT1 instruments are subject to conversion into ordinary shares after a certain period of time – i.e. typically on the mandatory conversion date (approximately 8 years from issue) if not previously redeemed on an earlier call date.

This position is consistent with Example below in paragraph 19 of DIPN 53 which provides:

Example

Bank-HK issued Perpetual Mandatorily Convertible Capital Notes of US$300m which qualified as AT1 instruments under Schedule 4B to the Banking (Capital) Rules. They would be mandatorily converted into Bank-HK's ordinary shares if they were not redeemed within 8 years of the issue date, based on the prevailing market price of the shares.

The Perpetual Mandatorily Convertible Capital Notes would be excluded from the definition of RCS under section 17A(2)(b) since Bank-HK could convert the Capital Notes into ordinary shares after a certain period of time (i.e. conversion would take place even though in situations not falling within section 1(k) and (q) of Schedule 4B to the Banking (Capital) Rules)."

Although the description above reflects the general position for AT1 instruments issued by taxpayers in Hong Kong, it is then necessary to overlay the calculation of the tax position of a PE in Hong Kong.

Hong Kong has further provisions (Article 17G) and accompanying guidance (DIPN 60) which requires the income tax position of a PE in Hong Kong to be calculated on the basis that the PE is a separate enterprise. Hong Kong applies the OECD AOA to calculate the profits of a PE in Hong Kong.

We refer to the guidance in DIPN 60, in particular the guidance that is particularly relevant to financial institutions in Appendix 1.

As part of calculating the tax position of a PE of a bank in Hong Kong there is a requirement to attribute a notional amount of equity and debt capital to the PE. Furthermore and relevantly, it is clear that in undertaking this notional calculation a PE can recognise AT1 instruments and can potentially claim deductions for distributions on notional AT1 instruments.

We refer to the description in Appendix 1 of DIPN 60, in particular, paragraphs 29 to 33 which provide that:

29. Section 50AAK(4)(b) in effect requires that a permanent "establishment of a foreign bank to have such equity and loan capital as it could reasonably be expected to have as if it were a distinct and separate enterprise, engaged in the same or similar activities under the same or similar *conditions. This means looking not just at the amount of equity capital that the permanent establishment would have at arm's length, but also looking at the mix of equity and loan capital that it would have if it were a separate enterprise trading in Hong Kong in the same or similar conditions.*

30. When considering the mix of equity and loan capital that the permanent establishment would have at arm's length, it is possible that in certain circumstances this mix could include interest-bearing regulatory capital securities (e.g. Additional Tier 1 and Tier 2, and banking loss absorbing capacity instruments).

31. The Commissioner does not accept that a permanent establishment would have the most tax efficient mix of capital that is theoretically possible (i.e. comprising the minimum amount of equity capital and the maximum amount of loan capital) because such capital structures are not in fact seen at arm's length.

32. Having established the equity and loan capital, which a permanent establishment would require, it is necessary to arrive at the hypothetical cost of such capital for the purposes of the capital attribution tax adjustment.

33. As far as the equity capital is concerned this will be nil. To the extent that there is deductible regulatory capital to be taken into consideration this will form part of the loan capital. The rate of interest to be applied to the total amount of loan capital will depend on a number of factors including the functional currency of the permanent establishment, the likely hypothetical mix of loan capital and to some extent the actual nature of, and rate of interest on, loan capital held by the permanent establishment and the bank of which it is part."

Although a PE of a bank is able to recognise deductions in relation to notional AT1, we understand that a bank PE will only be able to do this if the AT1 instruments that its head office has issued qualify as RCS.

This position flows from the fact that we understand that, in calculating the notional funding costs of the PE, these amounts are derived mainly from the terms of the relevant instruments (e.g. the AT1 instruments) that the PE or its head office have actually issued. This principle is reflected in the description of the calculation of the notional costs of the PE in DIPN 60 – see paragraph 77 that provides:

"77. The notional interest and other borrowing costs applicable to the permanent establishment loan capital requirement should be derived mainly from the actual terms, including interest rates and other charges, of actual loans borrowed by the non-Hong Kong resident person and permanent establishment. Other factors may then require adjustment such as where the actual loan currency differs from the functional currency of the permanent establishment."

As the AT1 instruments that are issued by Australian banks and subject to s.207-158 should not qualify as RCS (see the comments above), we understand that the PE of an Australian bank should not recognise deductions on these AT1 instruments as part of its notional capital/debt stack for Hong Kong income tax purposes.

For completeness, we also note that none of the banks have claimed or are intending to claim deductions in relation to notional AT1 instruments that are subject to s.207-158 as part of the notional capital/debt stack of their PEs in Hong Kong.

Proposed Methodology

We have set out below a number of specific comments on the 'second option' referred to in the Discussion Paper – see paragraphs 19, 20 and the example that follows.

Before going on to do this, we consider that the Discussion Paper should confirm that:

the calculation does not need to be applied in relation to PEs in the 19 jurisdictions in which the banks operate with very limited activities and assets;

the calculation does not need to be applied to PEs that the banks have in the United States, Singapore and New Zealand – on the basis that the relevant jurisdiction does not allow a PE of an Australian bank to claim any tax deductions (whether actual or notional) in relation to distributions paid on AT1 instruments issued by an Australian bank through its head office;

the calculation does not need to be applied in relation to PEs that the banks have in Hong Kong – i.e. for the reasons considered above; and

the methodology should be applied to PEs that the banks have in Japan and the United Kingdom

We consider that this type of clear statement is appropriate in a document which is setting out a compliance approach – as it will provide a degree of certainty for both the banks and the ATO. Clearly, to the extent that other jurisdictions change their tax rules in the future such that the list expands or contracts then both the banks and the ATO will have to monitor this and ensure there is appropriate compliance.

In relation to our specific comments on the methodology set out in paragraph 20, we note the following points:

Scope of AT1 instruments included

The methodology should not pick up in the calculation, either:

- AT1 instruments that are grandfathered and not subject to s.207-158 (i.e. broadly instruments issued before 9 May 2017); or
- AT1 instruments that are unfrankable as a result of being issued by a PE (in a listed country) in compliance with the conditions in s.215-10.

This principle is entirely logical as the calculation should only be looking to include an amount in assessable income in relation to those instruments that are caught within the scope of s.207-158 (the **In-Scope AT1s**).

By way of example, in the calculation it should only be the In-Scope ATIs that are reflected in:

- the determination of the issuer's AT1 capital in Step 2; and
- the impacted AT1 capital in Step 3

Scope of RWAs included

The calculation compares the RWAs of the issuer's PE with the global RWAs of the issuer.

It should be made clear that the determination of the RWAs is looking at the RWAs of the issuer - and not for instance, the RWAs of other group entities (including subsidiaries of the issuer).

Step 4

It does not seem clear to us that Step 4 is required. It would be simpler to only include in the calculations the jurisdictions in which a deduction is potentially available (i.e. Japan and the UK).

It seems to be unnecessary to undertake calculations for jurisdictions like New Zealand, Singapore, the US and Hong Kong (i.e. determining RWAs, etc) to then simply exclude these amounts.

It would also be helpful if some of these principles were reflected in the example – for instance, by factually including grandfathered and s.215-10 instruments within the example such that the example calculation would then clearly exclude them.

Concluding comments

As noted in the body of this submission, we aim to provide analysis on Singapore in the coming weeks.

Thank you for the opportunity to provide feedback. The ABA would like to thank Greenwoods and Herbert Smith Freehills for the authorship and co-ordination of Member comments for this Submission.

If you have any queries, please contact me at Prashant.ramkumar@ausbanking.org.au and for technical matters please contact Andrew Hirst at Andrew.Hirst@greenwoods.com.au>.

Yours sincerely,

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Associate Policy Director

About the ABA

The Australian Banking Association (ABA) advocates for a strong, competitive and innovative banking industry that delivers excellent and equitable outcomes for customers.

We promote and encourage policies that improve banking services for all Australians, through advocacy, research, policy expertise and thought leadership.