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Dear Karen

Implementation of the OECD anti-hybrid rules

Thank you for the opportunity to provide a submission on the issues raised in the Board of Taxation's November 2015 consultation paper.

Our comments below concern the treatment of regulatory capital instruments (ie, consultation question 35). We have also briefly commented on implementation timing and transitional issues (question 6).

Exception for regulatory capital

As you will be aware, prudential standards require authorised deposit-taking institutions (ADIs) and insurers to hold regulatory capital as a buffer to absorb losses during periods of financial stress.

The Action 2 report is not aimed at such instruments. It refers to regulatory capital instruments only once, noting that 'countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise under intra-group hybrid regulatory capital'.[1]

Nonetheless, there is some doubt as to whether certain types of Tier 1 capital instrument could fall within the scope of the anti-hybrid rules. (For example, depending on how recommendation 2.1 [Denial of dividend exemption for deductible payments] were interpreted and applied, distributions on certain Tier 1 capital instruments might be made unfrankable.)

We submit that the unique nature of regulatory capital instruments justifies their express *exclusion* from the anti-hybrid rules to put the position beyond doubt.

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[1] BEPS Action 2: 2015 final report: Executive Summary.

Specifically, we note that:

1 The current Australian tax treatment of Tier 1 capital instruments is consistent with Australia's existing policy settings and is well-settled.

Prudential requirements mean Tier 1 capital instruments are generally classified as equity interests for Australian income tax purposes. Moreover, unless relatively stringent conditions are satisfied, distributions are frankable and – because of the benchmark rule – necessarily fully franked.

These outcomes reflect Australia's existing policy settings.

We would support a broader review of the tax policy settings applicable to capital instruments. (We would expect this to include consideration of whether Australian banks should be able to issue deductible Tier 1 capital instruments – as has historically been the case for many European and US banks.)

But we believe it would be a mistake to modify the application of the imputation system in isolation. The framework governing regulatory capital instruments is complex, incorporating accounting, legal and regulatory considerations. We caution against making changes without considering the framework holistically.

2 Applying the anti-hybrid rules (and in particular recommendation 2.1) to hybrid capital instruments is unnecessary.

As an initial comment, we note that recommendation 2.1 does not *require* jurisdictions to deny non-exemption based dividend reliefs (eg, imputation) to prevent D/NI outcomes. In fact the Action 2 report expressly acknowledges that relevant differences exist between dividend exemptions and such reliefs. In that regard, we submit that Australia's imputation system innately and relevantly differs from an exemption system. An exempt recipient simply pays no further tax, regardless of the tax profile of the distributing entity. By contrast, an Australian corporate taxpayer can frank dividends only if it has paid tax itself. The relief for the recipient is thus finite, being limited to available franking credits. Moreover, the recipient may pay further tax (or receive a refund) depending on its circumstances.

In addition, we note that Australia already possesses what is widely considered one of the most robust general anti-avoidance provisions of any tax system globally. The inapplicability of Part IVA to a particular class of hybrid stapled securities (PERLS V) has already been confirmed by Australia's highest court,[2] with no subsequent changes to Australia's tax law deemed necessary by the legislature.

Finally, we note that very few countries today maintain a full imputation system (ie, with credit for underlying tax paid domestically). Whether to make distributions on Tier 1 capital

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[2] *Mills v Commissioner of Taxation* [2012] HCA 51.

instruments frankable is an almost uniquely Australian issue. There is no question of setting an international precedent.

3 Applying recommendation 2.1 to hybrid stapled securities (issued by an Australian bank out of a foreign branch) would in fact be counter-productive. Both:

- for Australia – because the imputation system encourages companies to pay tax in Australia and helps ensure the robustness of Australia's tax system. Making payments on regulatory capital instruments non-frankable would weaken this structural incentive; and
- for the foreign jurisdiction – because making distributions non-frankable is likely to result in the cash coupon on a hybrid stapled security increasing (to compensate holders), eroding the foreign tax base.

4 Applying the anti-hybrid rules to regulatory capital instruments risks making Australian banks uncompetitive.

Any adverse changes to the tax treatment of regulatory capital instruments is likely increase Australian banks' cost of funds – at a time when the Basel III reforms are significantly increasing capital requirements. Consequently, Australian banks may become less competitive relative to their international peers (which, as noted above, have historically been able to issue deductible Tier 1 capital instruments).

5 Applying the anti-hybrid rules to listed instruments would introduce significant administrative challenges.

The scope of the hybrid financial instrument rule is intentionally limited to 'strike a balance between a rule that is clear and comprehensive and that is properly targeted and administrable'.[3]

Listed capital instruments are commonly held by nominees. Many issuers will therefore be unable to identify quickly (or at all) the beneficial owners of their capital instruments. These practical difficulties will be exacerbated where instruments are actively traded and holders differ between payment dates.

Implementation timing and transitional issues

The Board's consultation paper cites 1 July 2017 as a possible commencement date for the anti-hybrid rules.[4]

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[3] BEPS Action 2: 2015 final report: paragraph 99 on page 44.

[4] Board of Taxation, Implementation of the OECD anti-hybrid rules: question 6 on page 5.

We note that the UK government, which issued its Consultation Document on 3 December 2014, is proposing a start date of 1 January 2017. Given it is now 2016, we would not support a commencement date for Australia earlier than 1 January 2018.

Further, if (contrary to our submission) the anti-hybrid rules are applied to regulatory capital instruments, we submit that there are sound reasons for grandfathering these or for providing an extended transitional period. In particular:

- Regulatory capital instruments, by their nature, involve a long term arrangement between issuer and holder. Any adverse law change is therefore likely to have a disproportionate impact on the parties concerned, compared to shorter-term arrangements.
- Applying the anti-hybrid rules to existing capital instruments may cause issuers to redeem these. If multiple issuers are forced to approach the capital markets for replacement finance over a short period of time, significant disruption may occur.

We note that the UK government (recognising the special circumstances applicable to regulatory capital instruments, and the need to ensure a level playing field within the UK financial sector) proposes initially to exclude regulatory capital instruments from its anti-hybrid rules so that it can further consider their appropriate treatment.

We would support:

- grandfathering existing regulatory capital instruments (eg those Tier 1 capital instruments issued before the anti-hybrid legislation receives Royal Assent); or
- providing an extended transitional period for regulatory capital instruments (for example, to 1 July 2019).

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Please contact us on the numbers above if you have any queries regarding our submission.

Yours sincerely

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