AFMA

19 October 2021

Law Division
Treasury
Langton Crescent
PARKES ACT 2600

Via Email: MiscAmendments@treasury.gov.au

Dear Treasury,

Second Round of Miscellaneous Amendments to Treasury Portfolio Laws 2021

The Australian Financial Markets Association (AFMA) represents the interests of more than 120 participants in Australia's financial markets. Relevantly, AFMA has as members the majority of the foreign approved deposit-taking institutions that are licensed by APRA to conduct business at or through a permanent establishment in Australia (**foreign bank branches)**. It is in this context that we make a submission to the second round of miscellaneous amendments to Treasury portfolio laws.

Specifically, Part 3 of the *Treasury Laws Amendment (Measures for Consultation) Bill 2021: Miscellaneous and Technical Amendments No. 2* (**the Bill**) proposes amendments to Section 160ZZZA of the *Income Tax Assessment Act 1936* (**1936 Act**), which, for those foreign bank branches that are taxed under Part IIIB of the 1936 Act, imposes a statutory cap on the deductibility of interest for expenses incurred by foreign bank branches on internal funding to the applicable LIBOR, referred to as the "LIBOR Cap."

AFMA does not agree with the proposed amendments to the LIBOR Cap and has steadfastly supported the abolition of the cap. Our submission sets out below the basis for our policy position and also the considerable concerns we have in terms of the specific proposed amendments.

Executive Summary

AFMA's position in relation to the proposed amendments included in the Bill are as follows:

- The LIBOR Cap has punitively operated in a manner inconsistent with its policy intent for many years and, given that the cap only applies to foreign bank branches, has adversely impacted banking competition;
- The proposed amendments in the Bill will exacerbate the current inequity imposed by the LIBOR Cap and undermine the operation of Part IIIB of the 1936 Act;
- The determination of the deductibility of interest costs by the bank is a matter of policy and it is inappropriate to delegate such a determination to the ATO, particularly where that delegation creates a conflict of interest;
- Australia's transfer pricing framework is sufficiently robust to ensure that the interest rate attaching to internal funding for foreign bank branches is based on arm's length conditions;
- Accordingly, the LIBOR Cap should be repealed and not replaced with any other capping mechanism based on benchmark rates.

Current Flaws with the LIBOR Cap

The LIBOR cap is one component of Part IIIB of the 1936 Act which was introduced in 1993 as a specific taxation code for foreign bank branches. Part IIIB treats foreign banks branches on a separate entity basis in respect of specified transactions. Importantly, foreign bank branches are able to elect out of Part IIIB where they are able to demonstrate that there is a better tax outcome outside of Part IIIB, potentially due to the application of a Double Tax Treaty. At the time of its inception, Part IIIB was the preferred mode of taxation for foreign bank branches. The relative certainty it provided was viewed as an advantage to Australia both in attracting foreign bank capital and business operations and increasing the competitiveness of Australia as a financial centre.

The LIBOR cap was designed to ease administration, rather than be punitive to foreign bank branches through significant denial of deductions on arm's length interest expenses. In the words of the Board of Taxation:

> "the LIBOR cap was introduced as an easily administered method of determining the foreign bank's actual interest costs for funds made available in the bank's Australian branch operations, where the bank could not reasonably determine what its actual interest cost for those funds was."

However, in recent times, the LIBOR Cap has operated in a manner contrary to its policy intent and has become punitive for foreign bank branches, resulting in such branches either electing out of Part IIIB or being at a disadvantage relative to their competitors due to non-deductibility of a significant portion of their funding costs, either outcome being problematic. Importantly, the amount determined under the LIBOR Cap is also the amount determined for interest withholding tax purposes, with this amount applying to all foreign bank branches, regardless of whether they have elected out of Part IIIB or not.

The punitive aspects of the LIBOR Cap arise due to the incorrect assumption the LIBOR rate is representative of the interest rate payable on the cost of foreign bank funding. This is incorrect because LIBOR does not represent the cost of short term funding for individual banks nor does it purport to be a measure of the actual cost of debt funds for a bank. In addition, prudential standards adopted in response to the global financial crisis required banks to materially lengthen their debt funding profile. With a maximum term of 12 months, LIBOR therefore significantly underestimates bank funding costs.

Further complications in applying the LIBOR Cap have arisen for currencies where no LIBOR has been quoted, either because LIBOR was never quoted (Singapore Dollar, Hong Kong Dollar) or LIBOR quotation was ceased (Australian Dollar). This has resulted in foreign bank branches seeking to determine an appropriate cap for deductibility of interest on internal funding where there is no legal basis to do so.

The Government asked the Board of Taxation to review the appropriateness of the LIBOR Cap as part of its review into the Tax Arrangements Applying to Permanent Establishments. The Board of Taxation made only one recommendation in its report to the Government, namely:

> "subject to confirmation that the removal of the LIBOR Cap would result in no material cost to revenue, the cap should be removed. That would assist in fostering competition in the domestic market."

In providing context to the recommendation, the Report stated:

> "The Board agrees that the LIBOR Cap has the potential to reduce bank competition. Put another way, it is hard to see how a cap on the amount of deductions that can be claimed in respect of intra-entity debt can assist in promoting banking competition by foreign banks with their

> domestic counterparts that do not face the restriction. The LIBOR Cap has the effect of potentially increasing the funding costs for foreign bank branches and hinders their ability to compete in the business loan market. Moreover, new entrants into the Australian banking market are likely to be disproportionately affected by the LIBOR Cap because they are relatively more reliant on head office funding to which the cap applies."

These comments follow on from those in the 2009 Johnson Report into Australia as a Financial Centre, which made the recommendation to "remove the LIBOR Cap on deductibility of interest paid on branch-parent funding."

Issues with the Proposed Legislative Approach

The proposed changes to the LIBOR Cap set out in the Bill are due to the fact that LIBOR is not going to be quoted in most currencies from 31 December 2021. This has resulted in a significant global effort to remove references to LIBOR in existing and new loan and derivative contracts. A key consequence of LIBOR cessation is that there will be no consistently determined benchmark with different approaches adopted in different currencies.

Noting the pending cessation of LIBOR, the proposed amendments seek to replace references to "LIBOR" in Section 160ZZZA of the 1936 Act with "qualified rate" being a rate determined by the Commissioner. Specifically, the Commissioner will have the ability to determine the qualified rate as either the rate of interest or the manner of working out the rate of interest for determining the deducibility of interest on internal funding.

AFMA holds considerable concerns with the proposed approach, as set out below.

Lack of Consistency in Determining Benchmarks

While the LIBOR Cap has continued to become incompatible with its initial policy intent and increasingly punitive, one advantage with the existing legislative framework is that LIBOR is calculated with a consistent methodology across each currency that is quoted. LIBOR is a forward-looking rate, with a term structure out to 12 months and hence incorporates a risk premium. Accordingly, the application of the LIBOR Cap is currently consistently punitive and should have similar effects for foreign bank branches regardless of the denomination of the internal funding.

However, the replacement rates for LIBOR are specific to each currency and determined on different bases. For example, Australia's Bank Bill Swap Rate (**BBSW**) is a forward looking rate with a term structure, albeit only to six months. This may be contrasted with the Secured Overnight Funding Rate (**SOFR**) from the US, which is a backward-looking rate for overnight funding and hence does not have a material credit element. Accordingly, to the extent that the Commissioner considered BBSW and SOFR to be "qualified rates," there will be a greater proportion of non-deductible interest for USD funding than AUD funding, all else being equal, which would appear to be an anomalous outcome. The varying structures of potentially qualified rates in different currencies will result in competitive distortions for foreign bank branches operating in Australia.

More generally, the expected manner in which LIBOR transition will be addressed in a number of jurisdictions is to replace the LIBOR with a risk-free rate with an appropriate credit margin to preserve economic equivalence on transition. To the extent that the Commissioner was to determine that the qualified rate is only the risk-free rate then the proportion of non-deductible interest will be higher and the inequities that currently exist with the LIBOR Cap will be exacerbated.

Delegation of Policy Matter to the ATO

Delegating a policy matter such as the determination of the deductibility of interest for foreign bank branches to an administrator such as the ATO is inappropriate. As noted in the ATO's Statement of Expectations issued by the Treasurer, Treasury is the principal body with responsibility for tax policy, with the ATO's role with respect to policy limited to facilitating consistency between the policy intent and its practical implementation. Given the impact on banking competition arising from the proposed legislation, to the extent that there is any determination of the rate(s) that are used to calculate the deductibility of interest on internal funding for foreign bank branches, then this determination should be a matter for Government. As expanded upon below, our view is that there is no need for such a determination to be made.

Additionally, the ATO is conflicted in having the unilateral authority to determine the deductibility of interest for foreign bank branches through the selection of qualified rates. To the extent that foreign bank branches are within Part IIIB, then the ATO will be required to opt for the lowest possible qualified rate for a particular currency to discharge its primary responsibility as the Government's principal revenue collection agency. It can only be the Government, on advice from Treasury, that has the capacity to balance competing objectives including the impact on banking competition in determining the qualified rate and delegation of this matter to the ATO is accordingly improper.

Costs of Compliance

AFMA takes issue with the comment in the Explanatory Statement to the Bill that the qualified rate will be able to be accessed by foreign bank branches at no cost. Many systemically important benchmarks globally require subscriptions for access and may only provide free access on a delayed basis. Given that any capping mechanism will be relevant not only for interest deductibility but also the calculation of interest withholding tax, then depending on which rates are determined to be "qualified rates," it is likely that foreign bank branches are going to incur significant compliance costs subscribing for access to such rates.

Likely Behavioural Response

As noted above, foreign bank branches are able to elect out of Part IIIB where they are able to evidence that there is a better tax outcome under the general provisions. Given the likelihood of a more punitive capping mechanism under the proposed changes, the likely behavioural response to the proposed changes is for foreign bank branches to elect out of Part IIIB, thereby leaving the provisions as largely redundant. This is contrary to the policy intent of Part IIIB, which was to be the primary taxing code for foreign bank branches and will expose such branches to greater uncertainty given that Part IIIB codifies separate legal entity treatment that specifically recognises certain internal transactions between foreign bank branches and other parts of the enterprise for tax purposes. Our position is that policy changes to Part IIB should have the effect of encouraging foreign bank branches not to elect out of Part IIIB.

As noted above, the capped amount is relevant not only for determining deductibility of interest expenses on internal funding for those foreign bank branches within Part IIIB but also for determining the amount of interest withholding tax payable by all foreign bank branches on internal funding, regardless of whether the foreign bank branch has elected out of Part IIIB. Accordingly, where the Commissioner sets a low qualified rate and the foreign bank branch has elected out of Part IIIB, the perverse outcome will be a reduction in interest withholding tax without any cap on deductibility of interest.

Preferred Policy Approach

AFMA's strong view is that there is no policy basis for the LIBOR Cap, or any capping mechanism based on benchmark rates, and that Australia's transfer pricing rules are sufficiently robust to ensure that interest rates applicable to internal funding are determined on an arm's length basis.

In the period since the inception of the LIBOR Cap, Australia's transfer pricing framework has become significantly more robust through the 2013 enactment of Division 815 of the 1997 Act. The Explanatory Memorandum to the Bill that introduced Division 815 states that the provisions in the Division:

> "seek to ensure that an appropriate return for the contribution made by Australian operations is taxable in Australia for the benefit of the community. The appropriate return is determined by the application of the arm's length principle, which aims to ensure that an entity's tax position is consistent with that of an independent entity dealing wholly independently with others… in addition, where the allocation of an entity's profits to a permanent establishment is relevant in determining its tax position, the arm's length principle ensures that this attribution is performed on the basis that permanent establishment was a distinct and separate entity dealing wholly independently with the entity of which it is a part."

Relevantly, this means that, regardless of the application of Part IIIB, foreign bank branches operating in Australia will need to ensure that the interest rate applicable to any internal funding received from other parts of the enterprise is consistent with that which would apply to external funding. Importantly, these provisions are intended to be aligned to the OECD Transfer Pricing guidelines and hence should mitigate double taxation where other jurisdictions have adopted consistent requirements.

As a result of the enactment of Division 815, foreign bank branches, in order to evidence to the ATO that they are compliance with the requirements, have undertaken considerable work to benchmark internal funding, and the interest rates attaching to such funding, to funding provided by external third parties. As such, adherence to the requirements of Division 815 means that the policy intention of the LIBOR Cap, being to provide a shortcut method for interest deductibility in circumstances "where the bank could not reasonably determine what its actual interest cost for those funds" has been completely superseded.

In this regard, we note with approval the conclusion of the Johnson Report which, in recommending the abolition of the LIBOR Cap, stated:

> "The Forum believes that any tax avoidance concerns resulting from removing the LIBOR cap could be adequately dealt with by applying the usual transfer pricing guidelines in respect of interest paid to foreign banks by their Australian branches."

The updating of Australia's transfer pricing rules subsequent to the release of the Johnson Report makes this comment even more compelling.

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Thank you for the opportunity to contribute to the proposed amendments to Part IIIB as set out in the draft Bill. I would be happy to discuss any of the matters that we have raised in this submission.

Yours sincerely,

Rob Colquhoun
Director, Policy