6th April 2018

The Manager
Base Erosion and Profit Shifting Unit
Corporate Income Tax Division
Revenue Group
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: BEPS@treasury.gov.au

Dear Treasury

Implementing the OECD Hybrid Mismatch Rules
Updated Exposure Draft and Draft Explanatory Memorandum

The Australian Financial Markets Association (AFMA) represents the interests of well over 100 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

We are pleased to make a submission on the updated Exposure Draft and draft Explanatory Memorandum for the legislation to implement the OECD Hybrid Mismatch Rules. This submission is to be read in light of our previous submission, as lodged with Treasury on 22 December 2017.

Implications for Foreign Bank Branches Within Part IIIB

AFMA is the primary industry body that supports foreign banks, particularly those that operate at or through a permanent establishment in Australia. We have been keen advocates for many years for the modernisation of Part IIIB of the *Income Tax Assessment Act 1936* (**the 1936 Act**) to ensure that it remains contemporaneous in light of financial innovation. For example, our submission to the "Re:Think" Tax Discussion Paper supported the retention of Part IIIB as the primary code for taxing foreign bank branches and that it be modernised to expand the definition of "derivative transaction" to include

Australian Financial Markets Association
ABN 69 793 968 987
Level 25, 123 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7955 Fax: +61 2 9776 4488
Email: info@afma com au Web: www.afma.com.au

credit, equity and commodity derivatives and to align Part IIIB to the definition of "financial arrangement."

Our view is that the proposed changes in the updated Explanatory Memorandum will have an effect opposite to that which we advocate on our behalf of our members, namely that in light of the proposed amendments, those foreign bank branches that are eligible to elect out of Part IIIB under Section 160ZZVB(2) will do so. This will result in Part IIIB applying to only a very small minority of foreign bank branches and, to the extent that our submission point below is implemented, potentially none at all.

The basis for our view is the requirement under proposed Section 160ZZZL for a foreign bank branch to neutralise a hybrid mismatch outcome by denying itself a deduction on a notional interest payment or a notional derivative payment where the amount of the deduction exceeds the sum of:

- the amount of the payment that is subject to foreign income tax;
- so much of the amount of the notional payment as it is reasonable to conclude is effectively funding non-deductible expenses; and
- the amount of profit of the branch that is subject to both Australian tax and tax in the country of residence.

The Explanatory Memorandum is silent on the obligations of the foreign branch to determine the tax treatment of the notional payment either in the recipient jurisdiction or the jurisdiction of residence. Given that banks, such as foreign banks to which Part IIIB applies, operate in a pool of funds environment and may have little to no visibility of the taxation outcomes for each branch of the global enterprise, the concern is that it may be difficult for the branch to confirm that the notional payment for which it is seeking to claim a deduction does not exceed the sum of the three amounts covered by proposed Section 160ZZZL(3). In the absence of such clarity, the branch may need to deny the deduction in its entirety. This is a particularly punitive outcome given the proposal that the amount of the notional payment, not the amount of the deduction, is the amount upon which withholding tax is calculated.

Ironically, by virtue of the LIBOR Cap in Section 160ZZZA(1)(c) in respect of notional interest payments, the amount of the deduction available to the foreign bank branch may be less than would be available under the transfer pricing provisions in Division 815-C, particularly for longer-dated funding.

AFMA supports refining the proposed amendments to Part IIIB to implement the branch hybrid mismatch rules in a manner that neutralises a clear hybrid mismatch, but that the deduction would not otherwise be denied to the foreign bank branch. This could potentially be done with reference to the books and records of the branch or where the quantum of the deduction available to the branch does not exceed the amount available

assuming Part IIIB did not have any application (i.e. the arm's length amount determined under Subdivision 815-C).

Recommendation 1: That the proposed Section 160ZZZL be refined to require that the deduction for the notional payment be denied to the foreign bank branch where the branch is aware, or ought reasonably be aware, that the amount of the notional payment is not subject to foreign tax.

Noting the comments above, AFMA expects that to the extent that the proposed legislation remains in its current form, the expected behavioural response is for eligible foreign bank branches to elect out of Part IIIB, thereby resulting in the regime being largely redundant.

Given our understanding that a core objective of the implementation of the anti-hybrid rules is to allow for affected taxpayers to alter behaviours so as to eliminate a hybrid mismatch before it is neutralised, it is our contention that the ability to alter behaviour needs to be competitively neutral. In this light, we propose an amendment to Section 160ZZVB to allow for all foreign bank branches to be able to elect out of Part IIIB so as to remove the application of the anti-hybrid rules.

Currently, in order to be eligible to elect out of Part IIIB, it is necessary that "an agreement within the meaning of the *Income Tax (International Agreements) Act 1953* that has the force of law applies in relation to the bank." In essence, this means that where the location of residence foreign bank branch is not a jurisdiction that has a Double Taxation Agreement with Australia, then the branch is precluded from electing out of Part IIIB.

Given our view as to the likely behavioural response to the proposed changes to Part IIIB, it is appropriate that all branches be in a competitively neutral environment.

Recommendation 2: That the words "and an agreement within the meaning of the *Income Tax (International Agreements) Act 1953* that has the force of law applies in relation to the bank" be removed from Section 160ZZVB.

Finally, given that the election to apply Part IIIB is in respect of "taxable income of that year of income," then unlike the other anti-hybrid rules it is appropriate that the changes to Part IIIB also apply from income years starting on or after a certain date, as opposed to a hard start date. As per our previous submission, this should be in accordance with the OECD guidance in implementing anti-hybrid rules.

Recommendation 3: That the amendments to Part IIIB apply to income years starting on or after the commencement date.

Commencement

Further to the comments above, we note that, as currently drafted, the rules will commence to apply to payments made six months after Royal Assent, i.e. a hard start

date. We further note our previous submission that called for a commencement that applied to income years starting on or after a certain date.

Further discussions subsequently have suggested that commencement of the anti-hybrid rules may be 1 January 2019, with the Imported Mismatch Rules to commence on 1 January 2020, so as to align with the commencement of the commencement of the rules in the European Union.

In respect of those branches or subsidiaries that are headquartered in other jurisdictions, the task of implementing the anti-hybrid rules in Australia in advance of commencement in the home jurisdiction will be difficult given the expectation that ascertaining the scope of the provisions will require significant head office assistance. As such, we would support deferral of commencement to 1 January 2020 for subsidiaries or branches that are domiciled in jurisdictions that will have anti-hybrid rules commencing operation at that time.

At a minimum, there should be no requirement for the secondary response to apply in an Australian context prior to the commencement of similar rules in a jurisdiction where, once the jurisdiction adopts anti-hybrid rules, that jurisdiction has the primary obligation to neutralise the hybrid mismatch.

Recommendation 4: That the commencement of the anti-hybrid rules be deferred to 1 January 2020 in respect of branches or subsidiaries for which head office is headquartered in jurisdictions that that implement anti-hybrid rules at that time, particularly where Australian branch/subsidiary would otherwise be required to adopt a secondary response.

Administration

Further to the comments in relation to the proposed specific amendments to Part IIIB, we note more broadly that the proposed rules are based on an assumption that the Australian operation has a detailed understanding of the taxation treatment of each payment made to a related party in an offshore jurisdiction. In a banking context, this is difficult both given the significant number of related party payments that are made and also because, in a pool of funds environment, it is impractical to trace funds through offshore entities. As such, the legislation and the Explanatory Memorandum should provide guidance as to the efforts that need to be undertaken by the local personnel to ascertain whether a hybrid mismatch has arisen, such as reasonable enquiries.

Recommendation 5: That the legislation and Explanatory Memorandum provide guidance as to the efforts that should be undertaken to determine whether a hybrid mismatch has arisen, particularly in a banking context (i.e. a pool of funds environment).

Imported Mismatch Rules

The issues in relation to the administration of the anti-hybrid rules for non Australian headquartered entities/branches are particularly concerning in respect of the imported mismatch rules. Our understanding is that these rules require the tracing of each payment through interposed foreign related parties to determine whether the payment has effectively funded a hybrid mismatch. This is at odds with the pool of funds approach which underpins the administration of taxation laws for banks and accordingly will be impractical to administer. As such, we submit that the imported mismatch rules only apply in a banking context where the local operation knew, or ought reasonably to have known, that the payment would give rise to a hybrid mismatch.

Recommendation 6: That the legislation clarify the limited application of the imported mismatch rules in a banking context, and confirm that there will be no obligation to trace funds through offshore related parties.

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Thank you for the opportunity to make a submission on the updated Exposure Draft and draft Explanatory Memorandum. We would be happy to discuss any of the matters that we have raised in this submission. Please contact me on (02) 9776 7996 or rcolquhoun@afma.com.au .

Yours sincerely,

Rob Colquhoun
Director, Policy