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Banking on tax

Focusing on the core issues

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Articles:

ATO practice statements following the decision in the Macquarie Bank case

The recent decision in *Macquarie Bank Limited v Commissioner of Taxation [2013] FCA 887 (Macquarie Bank)* may have implications for ATO administration and audit practices. In the case, the Federal Court dismissed Macquarie Bank's application for an injunction to prevent the ATO from issuing amended assessments in an ATO audit of the bank's offshore banking unit (OBU).

The issue

Macquarie sought a review under section 5 of the *Administrative Decisions (Judicial Review) Act 1977 (the "ADJR Act")* and section 39B of the *Judiciary Act 1903*, as well as other administrative arguments. The primary administrative argument was the extent to which ATO officers were bound by ATO Practice Statements. Macquarie considered that the ATO had changed its interpretation of how expenses could be allocated to its OBU (i.e. that it had performed a U-turn). This was important to Macquarie because OBUs are effectively taxed at a concessionary 10 per cent rate compared to the normal 30 per cent rate for non-OBU business.

Macquarie submitted that the Commissioner had historically accepted an "industry practice" accounting allocation of OBU expenses where that allocation produced a "reasonable outcome". Macquarie sought to rely on the application of *ATO Practice Statement PS LA 2011/27* (Matters the Commissioner considers when determining whether the ATO view of the law should only be applied prospectively). The Practice Statement states that ATO officers should not apply a changed view of the law retrospectively except in extreme cases.

The decision

The court found that:

- The ATO's decision to issue amended assessments to Macquarie for prior year tax returns was not a decision to which the *ADJR Act* applies
- The Commissioner's powers under Australian taxation law (in this case to issue assessments under the *Income Tax Assessment Act 1936*) cannot be estopped by administrative decisions or conduct of ATO officers.

Importantly, the court did not make a finding on whether or not the ATO had performed a U-turn. Instead, Justice Edmonds held that the taxation law does not, expressly or impliedly, require or authorise the making of ATO Practice Statements, nor does it require or authorise the Commissioner to make a decision about whether or not to apply the law on a retrospective basis. Specifically, PS LA 2011/27 is *"not an exercise of any delegated law-making power and* *does not have statutory force*"..."*it cannot be described as an 'enactment'*". Accordingly, the decision of the Commissioner to apply the law retrospectively was not a decision under an "enactment" and therefore was not a decision subject to which the *ADJR Act* was applicable.

The Full Federal Court refused Macquarie Bank leave to appeal the Federal Court's decision. The Full Federal Court was of the view that the case would fail, or alternatively, had "no utility", as there was no basis upon which Macquarie could seek to enforce any adherence to the Practice Statement.

The controversy

ATO Practice Statements are issued by the Commissioner to give direction to ATO officers, and they are binding on ATO officers. They cover a range of issues relevant to audits (and tax controversy), including: exercise of information gathering powers; accountants' concession and ATO access to Board Papers on tax risk; imposition and remission of penalties; freedom of information; Part IVA; settlements; debt recovery; ATO escalation of technical issues; and the priority rulings process.

Practice Statements are made available publicly so that taxpayers and advisers know the framework within which ATO officers operate. They create a reasonable expectation of the way in which ATO officers will judge and decide certain issues. However, the decision of the Federal Court makes it clear that Practice Statements do not provide legal rights that taxpayers can use against the ATO. Rather, it is only the Commissioner that has the power to enforce Practice Statements on his own officers.

The controversy here is that there may be cases where ATO officers have not followed ATO Practice Statements and, following the *Macquarie Bank* case, there is no legal recourse available to taxpayers under the ATO Practice Statement.

The only remedy would be to communicate the concern with the ATO officers involved, perhaps combined with escalating any concerns to more senior officers.

Developments affecting allocation of expenses to an OBU

The audit issue that led to the *Macquarie Bank* case was the interpretation applied by the ATO of how expenses could be allocated to an OBU. As outlined in the previous issue of *Banking on Tax* (Uncertainty in proposed changes to the OBU regime), the former Government proposed a number of changes to the OBU regime to apply from 1 July 2013. One of the proposals was to consult with industry to address concerns with the allocation of expenses between OBU and non-OBU activities. As part of its statement on announced but unenacted tax changes released on 6 November 2013, the current Government said it would continue to work closely with stakeholders to develop targeted rules to address integrity issues with the current OBU rules and would commence consultation with industry. This consultation is likely to include the allocation of expenses to OBUs.

The Government also said that it would not proceed with the previously announced measure to exclude all related-party transactions with an OBU. Instead, it will develop a targeted integrity measure to provide certainty and help Australian banks to compete internationally.

Banks with OBUs should contribute to the consultation process and monitor developments, to ensure appropriate outcomes, particularly given the implications of the *Macquarie Bank* case. Deloitte will be closely involved with the OBU consultation process.

ATO commences online banking platform project

In early October 2013, the ATO commenced an "Industry Scoping Review" of the use by Australian customers of online banking platforms. The ATO issued questionnaires to a number of foreign-owned bank branches and subsidiaries operating in Australia. The ATO stated that it is interested in reviewing the source of revenues arising from services and products being provided by global banks to Australian customers via online banking platforms.

Deloitte's understanding is that the ATO's risk hypothesis arises from ATO audits of various inbound banks. The ATO review is broad in scope and involves questions addressing both permanent establishment and transfer pricing matters. The review appears to be seeking to identify situations where revenue is generated by the overseas banking group from Australian-based customers, through direct customer access via online systems or platforms.

The issue of concern presumably relates to whether any profits arising from such dealings are appropriately attributed on an arm's length basis to any Australian parts of the bank that may have had a role in generating that revenue.

The initial response period for the questionnaire was approximately two months. Feedback to the ATO indicated that its approach was too broad and it may be better served in first considering the issues on an industry-wide basis. There are encouraging signs that the ATO may be willing to adapt its approach.

Opportunities for tax functions as APRA raises the bar for risk management

APRA recently released draft *Prudential Standard CPS 220 – Risk Management* (CPS 220) and an updated draft *Prudential Standard CPS 510 – Governance* (CPS 510). The focus of the proposed standards is to ensure that there are designated and independent risk management capabilities to effect adequate and consistent monitoring and management of 'material risks' across the industry. The proposed standards will be finalised by the start of 2014 with compliance required by 1 January 2015.

Key requirements of the APRA draft standards

1. *Reshape risk management frameworks*
    - A board approved risk appetite statement
    - A risk management strategy that addresses, at a minimum, 'material risks'
    - A business plan that links to the institution's risk profile
    - A designated risk management function that is independent from business lines and centralised functions
    - Fit-for-purpose management information systems that provide for accurate information, stress testing and appropriate escalation of issues concerning an institution's risk profile
    - Internal and external processes for monitoring, managing and attesting to the adequacy of the risk management framework
    - Board accountability to ensure a strong and robust risk culture.
2. *Recalibrate risk governance*
    - Establish an independent risk management function controlled by a Chief Risk Officer reporting directly to the Chief Executive Officer and the Board Risk Committee (BRC)
    - Establish the BRC, chaired by an independent director, to advise on the development and implementation of risk management frameworks
    - The Board Audit Committee (BAC) to continue to focus on risk assurance matters
    - Obtain BAC endorsement to appoint or remove external auditors and Heads of Internal Audit.
3. *Refocus on fit-for-purpose risk settings and attestations*
    - Annual attestations as to the adequacy of an institution's risk management framework being fit for purpose
    - Annual and three-year comprehensive external risk management reviews extended to Authorised Deposit-taking Institutions.

Opportunities for tax functions

While the draft APRA standards apply to all areas of a bank, for tax, where risks have traditionally been managed separately to the overall risk management framework of a bank, the changes represent a significant opportunity.

By incorporating the tax risk management framework and governance in a bank's response to APRA's changes, a tax function can further raise its profile within the bank and concurrently respond to the ATO's focus on tax risk management and governance.

The ATO's focus will intensify over the coming years as it is currently consulting on how it will undertake reviews of corporate tax governance documents and procedures.

The ATO's expectations of tax risk management and governance, as set out in its large business and tax compliance booklet published in December 2012, include:

1. A documented tax risk management policy
2. A board-approved tax risk framework
3. Accurate and reliable information systems.

Key APRA requirements in the draft standards which will have an impact on the tax function and questions for a tax function to ask as the APRA standards are finalised and implemented include:

- *A board-approved risk appetite statement*: Does this statement include a risk appetite statement for tax? Does this statement take into account the 'new environment' with the increased media focus on base erosion and profit shifting and responsible tax? Does the statement clarify to the business what transactions are appropriate from a tax risk perspective and when tax input needs to be sought?
- *A risk management strategy*: Have key tax risks been identified, not just within the central tax function but also across the bank (e.g. indirect tax risks in the finance function, employment tax risks in HR and payroll, etc.)?
- *Fit-for-purpose management information systems*: Have the systems been reviewed to ensure that they provide the appropriate information for tax? Systems should be reviewed for accuracy, but opportunities should also be considered to potentially identify and substantiate the tax treatment of particular income and expenditure
- *Signed annual risk management framework declaration*: Has tax been included in this review and sign-off process? In the UK, CFO sign-offs on tax processes to comply with the Senior Accounting Officer requirements have led to a greatly increased profile for the tax function in many organisations.

There are numerous cross-overs between the requirements of the ATO and APRA. Although the changes may require some effort in the short term, they represent a great opportunity for the tax function to further raise its profile in the organisation and get a seat at the table.

Spotlight on tax themes and recent tax developments for banks in Asia

There continues to be many tax developments across Asia. Outlined below are just a few of the themes and more recent tax developments that affect banks and other financial institutions throughout the region.

Tax reform – a feature of the Asian tax landscape

The Japanese Government confirmed on 1 October 2013 that the Japanese consumption tax (JCT) rate will increase from 5 per cent to 8 per cent from 1 April 2014. The Government indicated that it expects to announce in August 2014 whether the second planned increase to 10 per cent tentatively scheduled for October 2015 will proceed.

The Japanese Government also released an outline of 2014 tax reform proposals which seek to stimulate business investment. Key proposals include:

- Introduction of a tax regime to promote venture capital investment: companies acquiring shares of a company through an investment limited partnership will be allowed to deduct part of the reserve for losses on such an investment
- Introduction of a tax regime to promote business reorganisation: qualifying companies will be allowed a partial deduction for the loss reserve on investments that relates to losses suffered from a decline in price of specified shares or debts
- Repeal of the special reconstruction corporate tax one year ahead of schedule: a 10 per cent surtax was to be applicable for three years from the fiscal year beginning on or after 1 April 2012. The early repeal will reduce the corporate effective tax rate from 38 per cent to 36 per cent.

Important regulatory reforms

In late September, the Chinese government officially launched the China (Shanghai) Pilot Free Trade Zone (FTZ) and related Administrative Committee. Among its many objectives is to open up the financial services sector in China.

The Chinese government is expected to use the Shanghai FTZ to introduce policy reforms related to the internationalisation of the renminbi, the introduction of market interest rates and the facilitation of cross-border trade and investment flows (including changes to the foreign exchange administration system).

While some tax concessions have been announced, the thrust is regulatory reform, not tax advantages. Several domestic and foreign banks have been approved to set up branches or sub-branches and others are considering this. The scope of financial services conducted in the Shanghai FTZ will be influenced by the continuing dialogue between industry and the FTZ administrators.

India's central bank announced on 6 November 2013 that it will permit foreign banks to convert their local operations from a branch structure to a local subsidiary. The announced rules provide "Near National Treatment" to a wholly owned subsidiary of a foreign bank. This will allow for opening of more branch outlets across India, an ability to raise rupee-based, non-equity capital and the possibility of acquiring private sector banks in India. However, a higher regulatory burden will be faced by foreign banks with a local subsidiary, including having to earmark 40 per cent of their lending to the "priority sector" (e.g. agriculture) and to commit more capital to India. Foreign banks will need to assess the strategic and business advantages of a local subsidiary, including tax considerations.

Regulatory developments increasingly have an impact on tax

Monetary Authority of Singapore (MAS) Notice 643, which deals with related-party transactions (RPTs) entered into by banks, highlights an overlap between regulatory compliance and tax. The guiding principle in MAS Notice 643 is that related parties must not derive inappropriate benefits from RPTs *"that are reflected in the books of the bank in Singapore, in relation to its operations in Singapore"*. The notice requires all RPTs to be conducted on an arm's length basis – i.e. (a) conducted free of conflicts of interest and (b) on no more favourable terms and conditions than similar transactions with non-related parties under similar circumstances. The expectation is that banks will identify all related parties and "assess all existing exposures" as well as implement new policies and procedures to meet the requirements set out in the notice. While MAS Notice 643 does not seek to introduce a new or distinct arm's length pricing standard to that required by the Inland Tax Authority of Singapore, existing transfer pricing policies and documentation will need to be reviewed and compared to the standard required by the notice. MAS Notice 643 will commence on 1 July 2014, but further consultation on it is anticipated.

Transfer pricing – a key tax challenge

Across Asia, transfer pricing developments include new rules and requirements and often aggressive tax audit positions being taken by tax authorities. For example, in Indonesia, SE-11/PJ/2013 (issued on 26 March 2013) states that "banking and insurance" will be one of the targeted industries for tax audits in 2013. The same tax circular notes that taxpayers, who have *"high incompliance [sic] in relation to its related party transactions, especially those that have significant offshore related party transactions"* will be chosen for tax audit. PER-22 (effective 1 July 2013) provides guidelines for transfer pricing audits for taxpayers with special relationships and "required forms and documents" are to be submitted within seven days from the date of a request. Details of the net operating profit of group companies in the supply chain may be requested. The combined effect of SE-11/PJ/2013 and PER-22 is to reinforce the importance of preparing transfer pricing documentation in Indonesia to mitigate transfer pricing audit risk in Indonesia.

A trend towards indirect taxes

In the recent Malaysian Budget 2014, the Finance Minister announced the introduction of a Goods and Service Tax (GST) for Malaysia, effective from 1 April 2015, at the rate of 6 per cent, which will replace the current sales tax and service tax. Businesses have about 17 months to prepare for the Malaysian GST.

Financial services are to be treated as an exempt supply, although fee-based supplies such as loan-processing fees will be treated as taxable supplies. Life insurance/reinsurance will also be treated as exempt supplies. GST guidance has previously been released for insurance, funds management, hire purchase, credit leasing and money lending activities. GST guidance for the banking industry has not yet been released. The

Malaysian Government's intention is to introduce a Fixed Input Tax Credit (FITR) mechanism for financial services. This is similar to the mechanism used in Singapore. It is understood that the GST guidance for banking and the FITR mechanism should be released by the end of this year.

Specific integrity rule to address dividend washing

In the 2013-14 Budget papers, the previous Government announced it would close a legislative loophole that allows sophisticated investors to engage in so-called 'dividend washing'. Following submissions from a number of parties, the Government announced that it would achieve this objective by inserting a specific integrity rule into the imputation provisions. The current Government confirmed on 6 November 2013 that this measure will proceed as announced by the former Government.

What is dividend washing?

When shares are traded on an ex-dividend basis, the right to the announced dividend is retained by the seller of the shares. However, Trading Participants of the Australian Securities Exchange (ASX) can request that special cum-dividend markets be established for the two business days after a share goes ex-dividend. The special cum-dividend markets were originally developed to enable cum-dividend shares to be acquired and delivered after the ex-dividend date to satisfy delivery under option arrangements exercised before the shares went ex-dividend. The right to the dividend is transferred to the purchaser of the shares when shares are traded on a cum-dividend basis.

Generally, dividend washing occurs where a shareholder sells shares on an ex-dividend basis and purchases shares on a cum-dividend basis.

In this situation, the shareholder receives two dividends. However, the shareholder may also be able to claim two sets of franking credits attached to the dividends, despite effectively only holding one parcel of shares at all relevant times.

Circumvention of the imputation regime

The imputation system seeks to prevent shareholders from trading in franking credits through the following provisions:

- The holding period and related payment rules (former Division 1A of Part IIIAA of the *Income Tax Assessment Act 1936* (ITAA 1936))
- The general anti-avoidance rules (Part IVA of the ITAA 1936).

The holding period rule requires shareholders to hold ordinary shares at risk for 45 days (90 days for preference shares) in the "qualification period" starting on the day after the shares were acquired and ending 45 days (90 days) after the day the shares go ex-dividend, in order to claim franking credits attached to the dividend. The holding period rules also include a "last-in first-out" (LIFO) rule, which deems shares on which a dividend has been paid and which have been sold after the ex-dividend date to be the most recently purchased shares.

By selling the ex-dividend shares before purchasing the cum-dividend shares (or just buying cum-dividend shares), the LIFO rule may not apply. So long as the shares are held at risk for the requisite amount of time, the shareholder may then be able to claim two sets of franking credits. Both parcels of shares need to be held for 45 days (90 days) starting the day after the day the shares were acquired and ending on the 45th day (90th day) after the day the shares go ex-dividend to qualify for the franking credits attached to the dividend.

If the specific integrity rule in the imputation provisions (the holding period rule) does not apply to deny the franking credits on the second parcel of shares, Australia's anti-avoidance provisions in Part IVA of the ITAA 1936 would need to be considered in assessing whether or not a taxpayer is ultimately likely to receive both sets of franking credits.

Legislative approach to deny franking credits from dividend washing

The Government released a Discussion Paper on 3 June 2013, which considered three potential approaches to prevent dividend washing. A number of submissions were made on the Discussion Paper. Subsequent to this consultation process, the former Government announced that a specific integrity rule to prevent dividend washing would be inserted into the imputation provisions. As outlined above, the current Government will proceed with this change.

The integrity rule will apply where an entity (or its associate) disposes of shares on an ex-dividend basis and then acquires substantially identical shares on a cum-dividend basis in the period between the ex-dividend date and the record date (usually four days after the ex-dividend date). The franking credit attached to the dividend on the cum-dividend parcel of shares will not be included in assessable income and a tax offset will not be allowed for the franking credit

(i.e. the entity will be treated as if it had received an unfranked dividend on the shares purchased cum-dividend).

It is intended that this integrity rule will have application from 1 July 2013, and will apply to investors that have franking credit tax offset entitlements in excess of $5,000. Further consultation on the integrity rules is expected to occur following release of exposure draft legislation.

ATO approach until the integrity rule is enacted

According to the media release by the Australian Tax Office (ATO) on 3 October 2013, it is the ATO's view that dividend washing is ineffective under the current anti-avoidance provisions. Under paragraph 177EA(5)(b) of the ITAA 1936, we understand that the Commissioner takes the view that he can deny the franking credits received on either or both parcels of shares, on the basis that the arrangement is a scheme entered into for the purpose of obtaining franking credit benefits. The ATO intends to release a public ruling on this issue.

We further understand that the ATO is currently in the process of reviewing ASX records to determine taxpayers that might have been involved in dividend washing and brokers or advisers that might have been involved.

Guidance for reduced input tax credits for managed investment schemes

On 1 July 2012, new rules were introduced that modified the way in which the reduced input tax credit (RITC) rules apply to a variety of "recognised trust schemes", including managed investment schemes (MIS). However, little practical guidance was made available to taxpayers to assist them in navigating these rules. Recently, the Commissioner of Taxation released some new information that should assist taxpayers in applying these rules.

New RITC rules

Under the pre-July 2012 rules, an MIS that only makes input-taxed financial supplies was entitled to a 75 per cent RITC on certain qualifying expenses, including single responsible entity (RE) services, trustee services and administrative and investment portfolio management services. From 1 July 2012, the recoverable RITC percentage has been reduced to 55 per cent, but would now encompass a much larger range of supplies acquired by the MIS. The 75 per cent RITC would still be available, but only "to the extent" that it related to certain types of services, including certain investment portfolio management (IPM) functions, certain administrative functions and the provision of a custodial service.

From 1 July 2012, an MIS has been required to analyse its acquisitions in greater detail to correctly determine its input tax credit entitlement. There is also added complexity where a service may encompass different elements: a part that would be eligible for the 55 per cent RITC and a part that would be eligible for a 75 per cent RITC.

While the new rules allow the taxpayer to apportion such acquisitions to calculate its entitlement, until now, there has been little guidance on what would constitute an acceptable methodology.

The methodology in GSTD 2013/3

The Commissioner issued GST Determination GSTD 2013/3 on 25 September 2013, with an effective date of 1 July 2012 (this document was previously released in draft on 8 May 2013 as GSTD 2013/D1 and has been finalised without amendment). GSTD 2013/3 examines the scenario where an RE receives a single fee, but its duties comprise some activities that would be eligible for the 55 per cent RITC and other activities that would be eligible for the 75 per cent RITC. In GSTD 2013/3, the Commissioner proposes a "deductive benchmarking methodology" as a fair and reasonable method of apportioning this fee.

The methodology involves a three-step process:

1. Determine the benchmark market value (in basis points) of the particular service eligible for the 75 per cent RITC (e.g. IPM)
2. Use the benchmark market value to calculate a percentage of the total basis points of the fee and apply that proportion to the single fee to calculate the amount eligible for the 75 per cent RITC
3. A 75 per cent RITC is claimed on the calculated amount, while a 55 per cent RITC is claimed on the remainder of the fee.

Actions in light of these developments

Due to the retrospective application of GSTD 2013/3, managed investment schemes should review processes and recovery calculations to ensure that the approach taken to calculate the fund's entitlement to the 55/75 per cent RITC is consistent with GSTD 2013/3. If a more conservative approach than the approach outlined in TD 2013/3 has been taken, there may be an opportunity to increase the RITCs claimed over historical and future periods.

The ATO has also highlighted in a number of recent presentations to large business taxpayers and tax professionals that the area of 'recognised trust schemes' will be one of the key focus areas of their compliance plan for the 2014-15 year and, as a consequence, this issue will need to be monitored.

Globalisation of FATCA for multilateral exchange of tax information

In *Banking on Tax #10*, we highlighted the broadening of the U.S. *Foreign Account Tax Compliance Act* (FATCA). In particular, the OECD report released on 18 June 2013, which set out the steps needed to create a fairer and more transparent global tax system, referenced FATCA and the Model 1 Intergovernmental Agreements (IGAs) as providing a framework for multilateral automatic exchange of tax information (AEI). This multilateral AEI project is sometimes referred to as global FATCA or "GATCA".

In the G20 Leaders' Declaration from the meeting of 5-6 September 2013, the G20 stated full support for the OECD project, with an (ambitious) timetable as follows:

- February 2014 – expected presentation of a single global standard for multilateral AEI
- Mid-2014 – finalised technical requirements
- End of 2015 – multilateral AEI commencing among G20 members.

The OECD has been working on the multilateral AEI framework and consulting with OECD members as to its form and timing. In October 2013, the OECD held working group meetings with representatives from industry and government on a proposed model agreement for multilateral AEI.

There will be a number of differences between FATCA and GATCA to remove aspects of FATCA that are U.S. specific and to adopt aspects of other AEI arrangements (e.g. the EU Savings Directive) and anti-money laundering standards.

These differences may affect definitions of financial institutions and financial accounts, limit the number of non-reporting entities, modify due diligence requirements and remove various concessions provided in FATCA.

Financial institutions in signatory countries will be required to identify all non-resident individuals, entities and non-resident controlling persons of non-financial entities, regardless of their country of residence, from a common starting date. The information to be reported will be similar to that required under FATCA.

While the project has broad support, given the number of issues and complexities in implementing FATCA, there is concern that the proposed timetable is too ambitious and that GATCA should have a start date at least 12 months after the start date of FATCA. In particular, there are a number of aspects of FATCA that have an expiry date or intended start date of 2016 or 2017, so those dates would provide an appropriate start date for GATCA.

It is intended that the OECD will present a final version of the model agreement to the G20 in February 2014. In addition, the OECD intends to release detailed guidance to ensure consistent implementation across jurisdictions. Once the model agreement and detailed guidance is made available, banks can assess the impact of GATCA and how current FATCA programs might be amended to address the requirements of GATCA. Australian banks with branches and subsidiaries in jurisdictions that do not have a Model 1 IGA may be more affected by GATCA, as those branches and subsidiaries will need to comply with GATCA requirements, which will be based on the Model 1 IGA.

AUD LIBOR discontinued – can the LIBOR cap in Part IIIB still apply?

In a number of previous *Banking on Tax* articles, we have commented on Part IIIB of the *Income Tax Assessment Act 1936* (Part IIIB deals with Australian branches of foreign banks) and the London Interbank Offer Rate (LIBOR) limitation on interest deductions under that part. On 1 August 2013, the ATO released a document titled, *Large business income tax strategy 2013-14*. In that document, the ATO identified Part IIIB for the banking and finance industry as a "matter of concern".

LIBOR is an interest rate based on the average interest rates at which a number of banks operating in London would lend to each other. Until mid-2013, LIBOR was quoted for different maturities and for different currencies (including the Australian dollar, or AUD). At the end of May 2013, the British Bankers Association decided to discontinue fixing a LIBOR for a number of currencies, including the AUD.

The only reference to LIBOR in the *Income Tax Assessment Acts* is in Part IIIB. Part IIIB deems internal funding provided to an Australian branch of a foreign bank to be borrowings and deems accounting expenses related to that funding to be interest incurred. However, Part IIIB limits the deemed deduction to the amount calculated by reference to the LIBOR. In addition, withholding tax of five per cent (rather than 10 per cent) is payable on the amount of deemed interest (subject to the LIBOR limitation).

If an Australian branch of a foreign bank has borrowings in currencies for which the LIBOR is no longer quoted (such as the AUD, New Zealand dollar, Swedish krona, Danish krone and Canadian dollar), there is an argument that the limitation for deemed interest deductions in Part IIIB can no longer apply.

In fact, it is our view that an interest rate cap should no longer apply (be it LIBOR or any other interest rate benchmark).

The Board of Taxation's review of tax arrangements applying to permanent establishments (i.e. a review of Australia's adopting the OECD's "functionally separate entity" approach for permanent establishments) included a review of Part IIIB. In response to the discussion paper issued by the Board of Taxation, Deloitte submitted that the LIBOR cap in Part IIIB should be removed, on the basis that it caused significant issues as the LIBOR was often significantly lower than the actual cost of funds. In our view, the arm's length principle (in conjunction with the existing thin capitalisation provisions) provides a more appropriate framework to determine the amount of interest deductible for foreign banks operating in Australia. This is consistent with the recommendation contained in *The Report on Australia as a Financial Centre* prepared by the Australian Financial Centre Forum.

The Board of Taxation provided its report on the taxation arrangements applying to permanent establishments to the previous Government in April 2013. To date, no response has been provided (and thus no copy of the Board of Taxation report has been made available). The announcement of taxation policy decisions to be included in the Mid-Year Economic and Fiscal Outlook is an opportunity for the Government to deliver its response and provide certainty for Australian branches of foreign banks.

A banking perspective on the recent tax reform announcements

Summary of unenacted tax measures announcement related to banking

On 6 November 2013, the Treasurer and Assistant Treasurer announced the Government's position on a backlog of 96 announced but unlegislated tax and superannuation measures. Of the unenacted measures, the Government identified seven measures that will not proceed, notably including the proposed repeal of section 25-90 and the proposed changes to the fringe benefits tax treatment of motor vehicles. The vast majority of outstanding measures were subject to further consultation, which has been expedited and undertaken in the two weeks following the announcement.

Some items that may be of particular interest to banks include:

- The proposed R&D eligibility cap has been retained at $20 billion, making this the final year of R&D eligibility for entities with Australian assessable income exceeding $20B
- Section 25-90 has been retained. A targeted anti-avoidance provision will be introduced following consultation
- The OBU changes that were announced in the Budget are proceeding, but with a narrower scope with some related-party transactions being permitted as OB activity (subject to a targeted integrity measure)
- The new managed investment trust regime will proceed as announced
- The integrity measure to prevent 'dividend washing' will proceed as announced and the re-write of the imputation integrity rules will be subject to further consultation
- FATCA is proceeding as previously announced, with the focus being on the signing and enactment of the intergovernmental agreement
- A number of tax consolidation changes will proceed as announced and others will be subject to further consultation
- A number of other measures were to be subject to consultation, but subject to the Government's predisposition not to proceed with these measures. These include:
  - TOFA, including hedging and foreign currency
  - Review of the foreign-sourced income (i.e. Controlled Foreign Company) regime
  - Limiting the scope of the debt/equity integrity rule (section 974-80)
  - Changes related to scrip-for-scrip roll-over, demergers and share buy-backs.

Policy decisions on a number of matters should have been resolved by 1 December, for inclusion in the Mid-Year Economic and Fiscal Outlook.

Where banks have lodged tax returns based on an announced measure that will no longer proceed, the position adopted should be reviewed to determine if amended assessments (and potential refunds) are required.

Deloitte's publication *The Tax Road Ahead – Considerations and actions for business* sets out further comments on the Government's position and highlights the key considerations and actions now that there is a clearer view of the tax road ahead.

Phase-down of interest withholding tax not proceeding

As discussed in *Banking on Tax #7*, the previous Government had announced that interest withholding tax (IWHT) rates on borrowings by financial institutions from foreign financial institutions or offshore retail deposits would be reduced over time to 5 per cent and that the IWHT rate on head office funding for Australian branches of foreign banks would be reduced over time to nil. These reductions in IWHT rates were to be funded from revenue raised by the Minerals Resource Rent Tax.

Although not covered in the unenacted tax measures announcement on 6 November, the Coalition announced in the lead up to the federal election that these IWHT rate phase-downs would not proceed under a Coalition government. Both measures were included in the recommendations in *The Report on Australia as a Financial Centre* prepared by the Australian Financial Centre Forum chaired by Mark Johnson (the Johnson Report) and in the report by an Australian Parliamentary Senate Committee on Banking Competition in 2011 to improve the industry's competitiveness in raising funds in domestic and global capital markets. Not proceeding with these IWHT rate reductions will have an adverse impact on funding costs for Australian banks that source funding from certain offshore markets. The impact of interest withholding tax rates on funding, amongst other tax considerations, may be considered as part of the Government's inquiry into the financial system, which is due to commence in 2014.

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