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Banking on Tax

Focusing on the core issues

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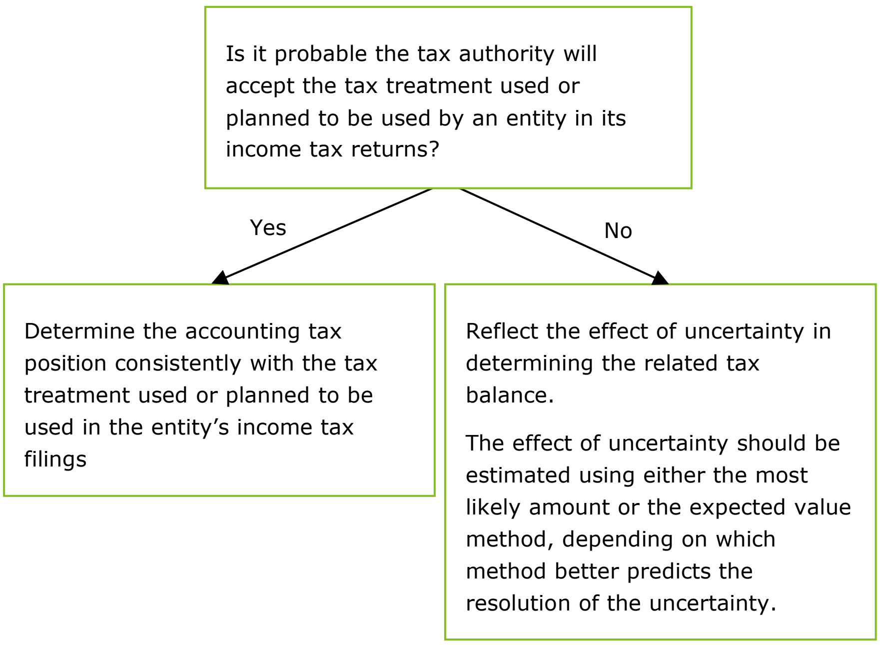
Contents

Reflecting uncertainty of tax treatments in financial statements

The Australian Accounting Standards Board (AASB) approves *AASB Interpretation 23 Uncertainty over Income Tax Treatments*

The Interpretation sets out how to determine the accounting tax position when there is uncertainty over income tax treatments (i.e. whether the tax authority will accept the tax treatment).

An entity is required to first determine whether to consider each uncertain tax treatment separately or together with one or more other uncertain tax treatments, depending on which approach gives a better prediction of the resolution of the uncertainty. The entity then assesses whether, and how, an uncertain tax treatment affects the determination of an entity's tax balances as disclosed in the financial statements:



In determining whether the tax authority will accept the entity's tax treatment, and if not, the effect of the uncertainty on the entity's tax balances, the entity should assume the tax authority will examine amounts it has a right to examine and have full knowledge of all relevant information when making those examinations.

The Australian Taxation Office (ATO) considers that in applying the new guidance, entities should have regard to ATO public guidance as to what is likely to be disputed, as well as to the ATO's success in disputed matters in determining the likely resolution when there is a dispute.

Accounting observations

The Interpretation does not provide any further guidance on assessing whether it is probable the tax authority will accept the entity's tax treatment. This is an area where an entity will have to apply judgement or that could give rise to estimation uncertainty. In such cases, the entity should disclose the relevant information in accordance with *AASB 101 Presentation of Financial Statements* regarding significant judgements and assumptions used in preparing financial statements.

An entity is required to use consistent judgements and estimates for both current tax and deferred tax, and to reassess the judgements made and estimates used for any changes in relevant facts and circumstances. Reassessments are accounted for as a change in estimate.

The Interpretation does not specifically address interest and penalties associated with uncertain tax treatments. Whether interest and penalties are within the scope of the Interpretation depends on whether they are income taxes within the scope of *AASB 112 Income Taxes*, which is a separate assessment not addressed by the Interpretation.

Similarly, tax assets and liabilities acquired or assumed in a business combination are not addressed specifically. However, *AASB 3 Business Combinations* requires an entity to apply AASB 112 to account for deferred tax assets and liabilities assumed in a business combination. Hence, the Interpretation applies to such assets and liabilities arising from the assets acquired and liabilities assumed when there is uncertainty over income tax treatments.

Practical considerations

The implications of Interpretation 23 will need to be considered as it is adopted. In particular, any changes in the measurement of deferred tax balances will likely have implications for a bank's Tier 1 capital ratio. In addition, media teams and senior executives at general meetings should be prepared for additional scrutiny of any uncertain tax positions that may be disclosed.

Transitioning to Interpretation 23

The Interpretation is effective from annual periods beginning on or after 1 January 2019, however earlier application is permitted. Entities can apply the Interpretation using either of the following approaches:

- **Full retrospective approach**: this can be used only if it is possible without the use of hindsight. The application of the new Interpretation will be accounted for in accordance with *AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors*, which means comparative information will have to be restated;

- **Modified retrospective approach**: no restatement of comparative information is required or permitted. The cumulative effect of initially applying the Interpretation will be recognised in opening equity at the date of initial application, which is the beginning of the annual reporting period in which an entity first applies the Interpretation.

Although the Interpretation is not effective until 1 January 2019, the AASB recommends all companies reassess whether to record any tax liabilities in earlier financial reports.

The entity should assume that the tax authority will examine amounts that it has a right to examine and have full knowledge of all relevant information when making those examinations.

Facilitation of tax evasion – the new UK corporate criminal offence

New UK rules on preventing the facilitation of tax evasion have a global reach and potentially affect Australian banks with branches in the UK.

The UK Government has introduced two new 'corporate criminal offences', enabling the easier prosecution of businesses which fail to prevent the facilitation of UK or overseas tax evasion. This legislation applies to all companies and partnerships ("businesses") that fail to prevent the facilitation of UK tax evasion by their employees, suppliers, contractors or other associates.

Coming into effect on 30 September 2017, the measures aim to improve governance and make it easier for the UK Government to prosecute organisations where there has been either:

(a) Failure to prevent the facilitation of UK tax evasion anywhere in the world

(b) Failure to prevent facilitation of foreign tax evasion where this was facilitated by a business with a UK branch.

Where one of these offences has occurred, organisations will be automatically liable for unlimited financial penalties unless they can prove that 'reasonable procedures' were in place to prevent such facilitation at the time the facilitation occurred.

Who may be seen as acting on an organisation's behalf?

The definition of an 'associated person' of an organisation has been widely drafted and will essentially capture any individual or entity that is seen as acting *"for or on behalf of"* that organisation. This can capture third parties such as agents and certain suppliers, in addition to employees and contractors.

Application to Australian businesses

The offences have been broadly drafted and some common examples of how Australian businesses could be caught are:

- An associated person of an Australian legal entity, or any legal entity globally, helps a third party evade UK tax by concealing income
- A UK intermediary for an Australian business, acting as an associated person, helps a Singaporean taxpayer to conceal wealth by falsifying income statements and payment destinations.

What are "reasonable procedures"?

As mentioned, a key defence is the presence of reasonable procedures in place at the relevant time. The guidance states that what constitutes reasonable procedures is governed by six guiding principles:

- Risk assessment
- Proportionality
- Top level commitment
- Due diligence
- Communication (including training)
- Monitoring and review.

Once reasonable procedures have been identified and implemented, Her Majesty's Revenue & Customs (HMRC) expects the procedures to be regularly reviewed and to evolve as a business discovers more about the risks it faces.

Next steps

It is recommended that businesses take steps to understand the impact of this legislation. Primarily this will focus on the UK segments of the business, but the global application may also need to be considered, particularly should a similar offence be adopted by other jurisdictions.

A key first step is to understand if the rules may apply to your business. If they do, a risk assessment should be performed to understand the risks of tax evasion facilitation and what current controls can be leveraged to mitigate these risks. In determining if reasonable procedures have been applied, HMRC has indicated that not conducting a risk assessment will rarely be considered "reasonable". HMRC has also made it clear they do not consider reliance on existing anti-bribery and anti-money laundering processes to constitute reasonable procedures, and that tax evasion facilitation risk must be considered separately. HMRC expects businesses to implement reasonable procedures rapidly, initially focusing on the major risks.

Organisations should begin the risk assessment process as soon as possible, if they have not already done so, as the offences come into effect on 30 September 2017.

Reliance on existing anti-bribery and anti-money laundering processes are unlikely to constitute reasonable procedures, and tax evasion facilitation risk must be considered separately

The South Australian major bank levy

The South Australian Government is seeking to impose their own bank levy on the major banks.

Legislation to introduce South Australia's own major bank levy (SA levy) has passed the House of Assembly and now moves to the Legislative Council. Should the legislation pass both houses, the levy would come into operation from 1 July 2017, the same time as the Commonwealth's Major Bank Levy (MBL).

Application of the levy

The SA levy will apply to all banks that are subject to the MBL who either carry on a business in, or offer services to persons located in, South Australia. As such, the SA levy is likely to apply to the four major banks and Macquarie Bank Limited.

The SA levy is imposed on the same liabilities subject to the MBL. As discussed in Issue 15 of Banking on Tax, certain liabilities are carved out from the application of the MBL, including:

- Tier 1 capital
- Deposits covered by the financial claims scheme
- RBA settlement account liabilities
- Derivative liabilities, to the extent they are netted against collateral.

Levy amount

The rate is imposed at a headline rate of 0.015% per quarter multiplied by the "gross state product (GSP) percentage of the applicable liabilities." Broadly, this percentage will be determined by the South Australian Commissioner of State Taxation as the South Australian GSP divided by the national gross domestic product (GDP) for the previous two years, as published by the Australian Bureau of Statistics. Therefore, if South Australia's contribution to national GDP as a percentage was 6% for 2015/2016, the SA levy would be imposed at a rate of 0.0009% (6% x 0.015%) for the 2017/2018 year.

Practical matters

Similar to the MBL, taxpayers subject to the SA levy will be required to furnish a quarterly return with Revenue SA. At this stage, the particulars of the return are unknown, nor whether the return will align with that required for the MBL.

Furthermore, a taxpayer will be required to inform the Commissioner of State Taxation within 14 days of any amendment to their MBL liability. Failure to comply with this obligation could result in a $10,000 penalty.

Next steps

The Australian Bankers' Association (ABA) has been vocal in its opposition to the SA levy. It has mounted a public campaign against the SA levy, calling on South Australian residents to sign a petition to Premier Jay Weatherill and Treasurer Tom Koutsantonis. In the event the petition fails

The SA levy will apply to all banks that are subject to the MBL who either carry on a business in, or offer to persons located in South Australia.

and the SA levy passes both houses, the ABA has stated it will bring a High Court challenge against the SA levy on constitutional grounds.

Although the 2017-18 Budget for Western Australia (WA) did not contain a State-based bank levy, the WA Treasurer indicated that the Government will continue to consider a bank levy similar to the SA levy in the absence of significant reform of the GST distribution arrangements or other revenue raising measures by WA.

Unlocking capital and funding options for mutual banks

Mutual banks may have an opportunity to access alternative capital and funding arrangements if proposed regulatory developments proceed.

Mutual banks have publically argued that they are at a structural disadvantage to non-mutual banks due to limitations on particular funding arrangements that are accessible to non-mutual banks. The Australian Prudential Regulation Authority (APRA) has released a discussion paper for proposed changes to allow mutual banks to issue Common Equity Tier-1 (CET1) capital directly.

The ability to issue CET1-eligible instruments has the potential to provide mutually owned ADIs with additional capital management flexibility, enhancing their ability to compete more effectively.

Capital and funding limitations for mutual banks

The current limited ability to raise share capital restricts a mutual bank to retained earnings or debt capital to fund its operations. As retained earnings are slow to accumulate, and debt capital is riskier than share capital, mutual banks can face impeded access to; and an overall higher cost of; capital compared to non-mutual banks. Non-mutual banks can also issue interests that provide franked returns, which reduces the cash cost of funding.

Sources of this limitation

One commercial limitation is a core philosophy of mutual banks to reinvest the entire profits into the organisation. This philosophy is often reflected in the constituent documents, which preclude the payment of dividends. Even where a mutual bank wants to pay a dividend and its constitution allows a dividend to be paid, legal and regulatory mechanisms may limit the amount and the nature of the dividend. These limitations include, among other things, common law principles regarding mutuality as well as the applicable statutory framework, including the *Corporations Act 2001* (Cth) and the supplementary regulations issued by the Australian Securities and Investments Commission.

Further, the members of a mutual bank have a subordinated claim on residual assets, which conflicts with APRA's existing criteria for ordinary shares where shareholders effectively have an unlimited and variable claim on residual assets in the event of liquidation.

APRA's suggested approach

The changes proposed by APRA are intended to alleviate regulatory capital restraints faced by mutual banks. Amendments to Prudential Standard APS 111 in 2014 enabled mutual banks to convert, if relevant conversion provisions were triggered, Additional Tier-1 (AT1) and Tier-2 (T2) capital instruments to CET1 capital in the form of Mutual Equity Interests (MEIs). These amendments were intended to address the constraints faced by mutual banks which could not convert AT1 and T2 instruments to CET1 due to the inability to issue ordinary shares. However, these amendments did not adequately address the mutual banks' core regulatory capital constraint: that mutual banks cannot issue CET1 instruments directly.

APRA's discussion paper, CET1 capital instruments for mutually owned ADIs released in July 2017, proposes the MEI framework be expanded to allow mutual banks to issue CET1 instruments directly.

APRA suggests MEI holders would continue to be subject to an overall cap on residual assets based on the amounts paid in, however, members would retain the right to any surplus once MEI holders had been paid out.

Further, the MEI framework is proposed to be updated to allow distributions to be determined by a benchmark or index. However, distributions on all MEIs would not be able to exceed 50% of the mutual banks' net profit after tax for an annual period.

There would also be restrictions imposed on the amount of MEIs which may be included as part of a mutual bank's capital base. APRA is proposing a limit of 15% of the issuing banks' total CET1 capital.

While the discussion paper is open to submissions, it is difficult to predict the final form of these amendments. However, it is clear there is a desire for mutual banks to be able to more easily satisfy their CET1 requirements. The proposed changes could enable a mutual bank to issue an instrument that pays a frankable return – providing an opportunity to access funding on a more comparable basis.

Single touch payroll – the new frontier

The new Single Touch Payroll (STP) reporting framework will impact many employers in Australia from 1 July 2018.

From 1 July 2018, 'substantial employers' will be required to report to the ATO certain payroll information via Standard Business Reporting software, which will be linked to the employer's payroll system or outsourced payroll provider's system. All employers are expected to be required to be compliant by 1 July 2019.

STP applies to employers who employ twenty or more employees as at 1 April 2018 (including wholly-owned groups that employ in aggregate twenty or more employees). The number of employees employed by an employer must be determined strictly by headcount and not with respect to full-time equivalent numbers.

What needs to be reported?

The information to be reported through the STP framework and the timing for the reporting of that information is:

1. Payments of, or to, the following:
    - Salary, wages, commissions, bonuses, or allowances to employees
    - Company directors
    - Government office holders
    - Religious practitioners
    - Return to work payments
    - Employment termination payments
    - Unused annual and long leave payments
    - Parental leave pay
    - Seasonal labour.
2. The aggregate value of the amounts withheld from the above payments.
3. Where not already included in the amounts above, other salary and wages (as defined for superannuation guarantee purposes) paid to employees or the ordinary times earnings of the same employees.
4. Contributions made by an employer (or on behalf of the employer) to a complying superannuation fund or a retirement savings account, on behalf of an individual's employment (including contributions made for the purposes of reducing the superannuation guarantee charge percentage).

The amounts listed in 1 – 4 are required to be reported on or before the day those amounts are required to be withheld, regardless of whether the amounts have actually been withheld or paid to the ATO or the superannuation fund.

Some practical points to consider:

- The information to be reported via the STP framework must be employee-level information. It cannot be reported as a single cumulative total
- Until now, there has never been a requirement for employers to provide information to the ATO regarding superannuation payments made on behalf of individual employees (except during an audit or investigation). That information has only ever been provided directly (or through a clearing house) to the superannuation fund
- Employers that report the above items via STP will be relieved from a number of other reporting obligations under existing law. For example, employers will no longer be required to provide employees with a PAYG payment summary at the end of each income year, as the ATO will already be provided with all the information included on a PAYG payment summary. The ATO will provide the relevant information to the employee via their myGov account
- Employers could have voluntarily opted into STP from 1 July 2017. However, we understand that ATO systems were not ready at that date and the ATO has advised they will be ready to conduct testing on smaller employers from October 2017
- Employers may report other amounts via STP, such as reportable employer superannuation contributions and reportable fringe benefit amounts
- For the first 12 months, reporting entities will not be subject to administrative penalties unless first notified by the Commissioner.

Other related changes

The on-boarding of new employees will also change as a result of the new STP framework. Under the new system, employees will have the option to lodge the following information directly with the ATO via the employee's individual myGov online account:

- TFN declaration
- Choice of superannuation fund.

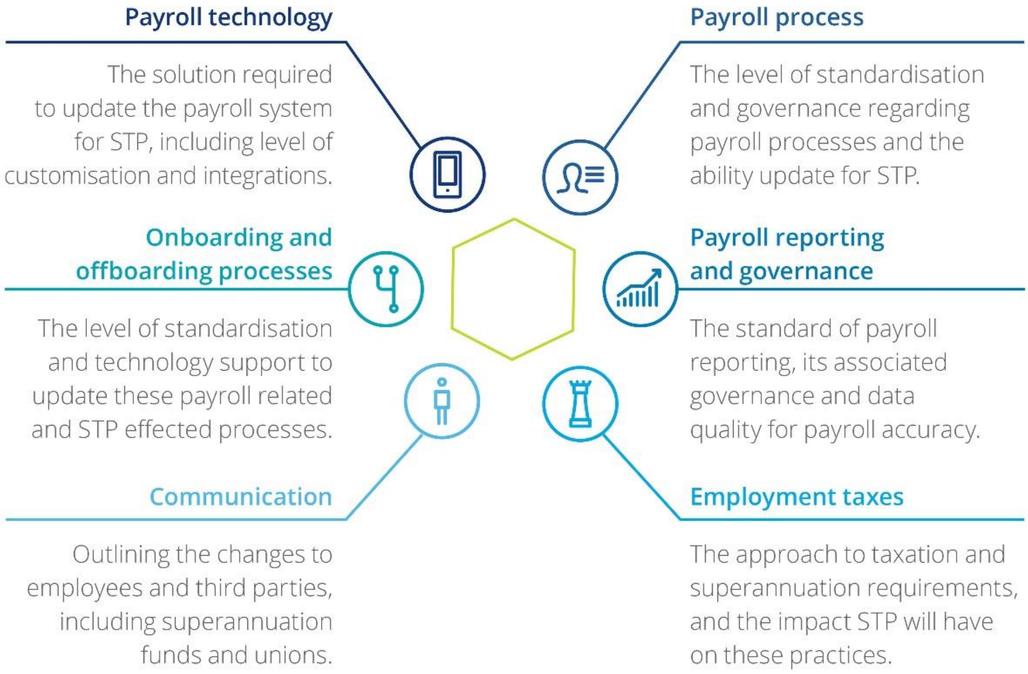
The Commissioner in turn has the power to disclose relevant information provided by employees via myGov to the employer.

Next steps

Although the new STP framework is driven by taxation legislation, the challenges of the STP relate to implementing the new technical requirements into an employer's business operations. The ATO is still working through many aspects of the STP process and requirements. These will continue to be developed over the coming months.

Employers should focus on reviewing current payroll systems and processes and understanding what needs to be done to prepare for the 1 July 2018 start date. Any review and planning should consider the following:

Although the new STP framework is driven by taxation legislation, the challenges relate to operational implementation of the technical requirements into an employer's business.



It is important for an employer to understand holistically the compliance challenge, as it will differ by organisation. Understanding the level of activity is critical to planning. The above approach will help to identify whether the payroll infrastructure can adapt to STP requirements and whether appropriate payroll controls are in place and documented. Ultimately, employers need to be satisfied that payroll will run with the level of accuracy that is required.

Patrick Broughan
Partner
+ 61 3 9671 6606
pbroughan@deloitte.com.au

James Pettigrew
Partner
+ 61 2 9322 5656
japettigrew@deloitte.com.au

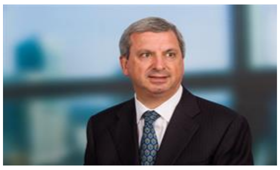
Patrick Grob
Partner
+ 61 7 3308 7230
pgrob@deloitte.com.au

Vik Khanna
Partner
+ 61 3 9671 6666
vkhanna@deloitte.com.au

Peter Radlovacki
Partner
+ 61 2 8260 4243
pradlovacki@deloitte.com.au

Greig Hubbard
Account Director
+ 61 7 3308 1242
ghubbard@deloitte.com.au

Geoff Gill
Partner
+ 61 2 9322 5358
gegill@deloitte.com.au



Steven Batrouney
Partner
+ 61 3 9671 7247
sbatrouney@deloitte.com.au

John Giannakopoulos
Partner
+ 61 2 9322 7827
jgiannakopoulos@deloitte.com.au

Owen Gibbs
Director
+ 44 20 7007 4819
ogibbs@deloitte.com.uk

Michael Velten
Partner – Singapore
+ 65 6531 5039
mvelten@deloitte.com

Alison Noble
Account Director
+ 61 3 9671 6716
alinoble@deloitte.com.au