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Banking on Tax

Focusing on the core issues

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Contents

Major bank levy – a tale of two cities

Although modelled on the UK bank levy, there are stark differences in the genesis and application of the Australian major bank levy.

The major bank levy, announced in the 2017-18 Federal Budget, surprised the banks and market. The banks effectively received no prior notification of the budget announcement with it being reported that Treasury rang senior personnel at each of the five affected banks one hour prior to the Treasurer's budget announcement. In the ensuing weeks, Treasury prepared the legislation with limited consultation and an accelerated start date – an experience quite unlike the introduction of the UK bank levy.

The London experience

The Chancellor of the Exchequer announced the introduction of a bank levy in the June 2010 Budget. This was followed by formal consultation between July 2010 and October 2010. Draft legislation was published on 21 October 2010 and, following further consultation, the legislation for the bank levy was introduced by Schedule 19 of the *Finance Act 2011*, taking effect from 1 January 2011.

The Canberra experience

On 9 May 2017, the Treasurer announced in his 2017-18 Federal Budget speech the introduction of a 0.06% levy on major banks with licensed entity liabilities greater than AU$100 billion. It was stated that the levy would "support budget repair" and is anticipated to raise AU$6.2 billion over four years.

The following week, the five affected banks received draft legislation. We understand that bank personnel were required to sign non-disclosure agreements precluding them from engaging with advisers and were required to provide feedback within 36 hours (increased from the original 24 hour time limit).

Without any further consultation, the *Major Bank Levy Bill 2017* and *Treasury Laws Amendment (Major Bank Levy) Bill 2017* were tabled in Parliament on 30 May 2017, with a start date of 1 July 2017. The Bills have passed both Houses without amendment and await Royal Assent.

The United Kingdom framework

The purpose of the UK bank levy was to:

- Ensure banks make a "fair contribution", reflecting the risks they pose to the financial system and wider economy
- Create an appropriate incentive to contain system risk and encourage banks to move away from riskier funding models.

The structure of the UK bank levy was based on the IMF report to the G20, *A Fair and Substantial Contribution by the Financial Sector* and applies to:

- Global consolidated balance sheets of UK banking groups and building societies
- Aggregated UK subsidiaries and branch balance sheets of foreign banks and banking groups operating in the UK
- The balance sheets of UK banks and UK branches of foreign banks in non-banking groups.

The levy applies to the bank's balance sheet at a current rate of 0.17% (up from 0.07% at introduction). Rather than a threshold for application, the first £20billion of chargeable equities and liabilities are not subject to the levy. This allowance aligns with HM Treasury's views on the correlation between the size of the bank/building society and its systemic risk.

To align the policy behind the levy with its mechanics, the UK levy provides various carve-outs to ensure that the entire liability side of the balance sheet is not subject to the levy. The carve outs include:

- Tier 1 capital, and debt used to fund high quality liquid assets (**HQLA**). This is to encourage banks to hold Tier 1 capital and HQLA for regulatory purposes
- Deposits covered by depositor protection schemes. This protects the bank from depositor withdrawals (and double taxation)
- Certain hedging liabilities can be netted against the corresponding assets. This netting reduces the funding risks of a bank and the exposure of the counterparty to a bank insolvency.

Other policy design features of the UK bank levy include the exclusion of certain non-funding liabilities (such as liabilities to pay compensation, tax liabilities and provision for the levy itself) and a lower levy rate for longer term liabilities. These design features are consistent with the purpose of the levy.

From an administrative perspective, the levy is imposed annually and supported by an anti-avoidance regime to unwind actions aimed at reducing the bank levy liability.

The Australian framework

The levy will apply to authorised deposit taking institutions (**ADIs**) whose licensed entity liabilities disclosed on a new APRA reporting obligation, *Reporting Standard ARS 760.0 ARO collection for Major Bank Levy Act 2017* (**ARS 760**), exceed AU$100billion.

The levy will be applied at a rate of 0.015% to the entity's liabilities for a reporting quarter (0.06% annual rate) with no reduced rate for long term liabilities. Unlike the UK, the AU$100 billion is an application threshold rather than a levy free threshold.

Similar to the UK levy, the major bank levy has carveouts so it won't apply to the whole of the bank's balance sheet. On budget night it was announced the levy would not be imposed on Tier 1 capital or deposits covered by the financial claims scheme.

Following consultation with Treasury, the major banks released media statements expressing their concerns over the levy applying in the following circumstances:

- **Derivative liabilities** - the banks argued if the levy did not allow for netting of derivative liabilities against collateral positions it would create a disincentive for them to participate in the market. This could lead to reduced liquidity in the market and/or a shift to foreign banks

The levy currently may apply to debt used to fund HQLA, intercompany liabilities and non-funding liabilities (including tax related liabilities). However, if the Australian experience is anything like the UK experience, further exclusions, especially for non-funding liabilities, may be introduced after enactment.

- **Intercompany liabilities** – if the levy were to apply to intercompany liabilities it would punish banks for having intercompany funding arrangements. This would be especially disadvantageous to internal securitisation arrangements
- **Debt used to fund HQLA** – imposing the levy on debt used to fund HQLA would be at odds with APRA's push for the banks to hold additional HQLA
- **Repurchase and money market activities** – similar to netting derivatives, imposing the levy on these liabilities may create a disincentive for banks to participate in this market which ultimately may lead to reduced liquidity
- **Non-funding liabilities –** imposing the levy on these liabilities would not be consistent with the policy intent of the levy and may lead to double taxation of deferred tax liabilities and provisions for tax.

The major bank levy effectively allows derivatives netting and provides an exclusion for RBA settlement accounts liabilities. However, the remaining requests were noticeably absent from the Bills tabled in Parliament that have now passed. Whilst the legislation provides the Minister may exclude further liabilities by legislative instrument, the levy currently can apply to debt used to fund HQLA, intercompany liabilities and non-funding liabilities (including tax related liabilities). However, if the Australian experience is anything like the UK experience, further exclusions, especially for non-funding liabilities, may be introduced after enactment.

Following the release of the revised *APS 120 Securitisation,* the accounting treatment of intercompany securitisation liabilities, in particular off-balance sheet securitisation liabilities, is uncertain. From a policy perspective, it should follow that securitisation liabilities that are allowed to be taken off balance sheet should not be required to be reported in the new APRA report and subject to the levy. However, the extent of the new report and the full extent of the levy is still unknown at this stage.

Administrative aspects

The levy will be assessed based on the liabilities reported in the new quarterly ARS 760 report. The report will be provided to APRA in the following quarter with payment made through the last business activity statement (BAS) of the following quarter.

As a transitional measure, the first report and associated payment is delayed until March 2018 (to correspond with the payment date of the second quarter). The relevant payment dates for the first year of the levy will be:

Quarter ending	Payment date
30 September 2017	21 March 2018
31 December 2017	21 March 2018
31 March 2018	21 June 2018
30 June 2018	21 September 2018

Consistent with the UK levy, an anti-avoidance regime has been introduced in the *Taxation Administration Act 1953* to ensure the integrity of the application of the major bank levy. The Explanatory Memorandum (**EM**) to the Bills provide three examples of activity that would fall within the anti-avoidance provisions:

- Artificially manipulating the balance sheet over quarter-end to achieve a lower liability value
- Temporarily transferring liabilities out of the reporting entity over quarter-end
- Entering into arrangements to move the liability off the balance sheet but the risk remains with the entity through another derivative instrument.

Mechanisms have also been put in place such that amended assessments can be challenged by applying Part IVC of the *Taxation Administration Act 1953*.

APRA reporting obligation

The administration of the levy will be based around a new ARS 760 APRA reporting obligation. Based on the draft released by APRA, the report will require a significant amount of data, including the daily value of a range of liabilities. The banks will need to provide new information in ARS 760 that is not currently provided to APRA.

This new reporting obligations therefore may necessitate significant work for the reporting banks. In the coming months, we expect the following projects will need to be undertaken:

- A gap analysis using current reporting obligations to determine the extra data that needs to be reported
- Overlaying the gap analysis with current reporting tools to determine whether the current infrastructure is sufficient to source the necessary data
- Where additional reporting tools are required, canvas the most appropriate options
- Once installed, conduct live testing to ensure that the new data solution is fit for purpose.

Once the new reporting tool is in place, banks will need to consider how the following will function:

- Management assurance procedures, including data integrity checks to ensure the data is robust
- A governance framework for the reporting obligation, including appropriate sign-offs. APRA has confirmed they expect the contents of the report are subject to external audit at least annually
- Use of automated reporting tools to limit the additional human resources costs.

Postscript

On 22 June 2017, the South Australian Government announced the introduction of their own "major bank levy". The final details of this levy are yet to be confirmed. However, we understand that the levy will apply to those banks subject to the Commonwealth major bank levy which operate in South Australia.

The levy will be imposed on the same liabilities subject to the Commonwealth major bank levy. The rate will be determined based on a product of the current Commonwealth major bank levy rate (0.015% per quarter) multiplied by South Australia's percentage contribution to Australia's GDP (currently around 6%). Therefore this will effectively double the major bank levy rate for South Australia's proportion of GDP contribution.

South Australian Treasurer, Tom Koustsantonis, stated the South Australian major bank levy is to recover lost GST revenue as financial supplies are input-taxed. This unilateral decision by South Australia may further complicate the debate between the States and the Federal Government on GST revenue apportionment. Should it be successful and not defeated on constitutional grounds, we may see other States follow South Australia's lead and introduce their own levy. Western Australia, in particular, is watching the progress of this levy as its government still to yet to hand down their 2017-18 budget.

A more workable approach to section 215-10?

The ATO has issued PCG 2017/10 on the application of section 215-10.

Section 215-10 enables an ADI to issue unfrankable additional tier 1 (**AT1**) capital out of a foreign branch. Without this provision, ADIs would need to frank returns on AT1 instruments that are largely issued to non-residents. This puts the ADI at a pricing disadvantage to its non-resident peers who can increase the cash yield in lieu of franking credits.

Section 215-10 compliant AT1 issues effectively stopped after the release of *Taxation Determination TD 2012/19 Income tax: when is a non-share equity interest 'issued at or through a permanent establishment' for the purposes of paragraph 215-10(1)(c) of the Income Tax Assessment Act 1997?* (**TD 2012/19**). In TD 2012/19, the ATO took a narrow view of when an instrument would be issued through a permanent establishment (**PE**). It essentially required that personnel associated with the particular issue would need to be employees of the branch – a requirement that does not align with commercial realities. Following industry consultation, the Commissioner of Taxation (**the Commissioner**) withdrew TD 2012/19 on October 2014 and has adopted a more practical application in *Practical Compliance Guideline PCG 2017/10 Application of paragraphs 215-10(1)(c) and 215-10(1)(d) of the* Income Tax Assessment Act 1997.

The Commissioner applies a risk-based approach in PCG 2017/10 to activities considered low, medium and high risk for (a) what it means to issue out of a permanent establishment and (b) the use of funds for a permitted purpose.

It is expected that, subject to commercial restraints, section 215-10 compliant issuances will start again. However, aspects of the analysis in PCG 2017/10 pose some administrative concerns.

Issued at or through a permanent establishment

The Commissioner acknowledges, whilst the issue of the AT1 capital must be a transaction of the branch, it is an activity that will involve non-branch personnel. In this context, "branch personnel" are considered to be those physically located in the branch and who conduct the business of the issuing branch.

While the nature and extent of involvement of branch personnel will depend on the structure of the particular organisation, the ATO considers an issuance will be low risk if the following activities are conducted by non-branch personnel:

- Preparing and negotiating the transaction documents
- Undertaking the formation and management of the syndicate of joint lead managers, including negotiating the offer management agreement

- Negotiating the structure and material terms of the capital raising including pricing, size of issue and final allocations of AT1 to investors
- Managing the book-build process
- Undertaking the necessary due diligence including obtaining approval from APRA, ASIC, ASX (and/or foreign stock exchanges)
- Undertaking marketing and investor roadshows (with assistance from branch personnel)
- Following issuance, managing any foreign exchange or interest rate risk exposures.

Whereas, branch personnel should be responsible for, at least:

- Executing and approving delivery of the transaction documents, including the offer management agreement (i.e. via approval from the Head of Branch)
- Appointing a registrar to maintain the note register (the ATO will accept a register located in Australia)
- Approving (or delegating final approval of) the necessary authorisations to the joint lead managers, clearing houses and registrar to offer and transfer the AT1 to investors.

For completeness, the ATO notes outsourcing some of the above functions will not, of itself, make the issuance higher risk, provided the key sign-offs and approvals are conducted by branch personnel.

Raised and applied solely for a permitted purpose

The funds from the AT1 issue are required to be raised and solely applied for a permitted purpose. When assessing the risk associated with complying with this requirement, the Commissioner will consider the following:

- The extent to which the funds are placed into a pool of funds
- Whether there is a going concern intention at the issue date the funds will be applied for a permitted purpose (see below)
- The proportion of funds applied for a specific or general purpose
- The period of time the funds are applied for a permitted purpose
- The extent and degree to which funds applied for use with related parties can be traced.

Pool of funds

The Commissioner recognises funds raised from the issuance of AT1 will in practice, contribute to a pool of funds used to support the business of the bank as a whole. However, there will be a high evidentiary burden on the taxpayer to prove the funds have not been used for a non-permitted purpose. When discharging this burden, the Commissioner accepts the following activities will not lead to a higher risk classification:

- Where banks have a practice of transferring surplus branch funds to the head office on a temporary basis. However, where there is an abnormally large, unexplained transfer, this may lead to increased compliance activity
- Where the head office conducts parallel fundraising initiatives. However, this activity could lead to the ATO considering the operation of franking credit streaming provisions.

Going concern intention

For an issuance to be considered low risk, the taxpayer must have a going concern intention at the date of issuance that the funds raised will be put to a permitted purpose. In this context, the ATO considers a "going concern intention” to be where there is no intention in the future to apply the funds for any purpose other than a permitted purpose. However, cognisant of the commercial realities of changing circumstances, the ATO will consider there is a low compliance risk where the funds have been applied for a permitted purpose for at least six months from the capital raising.

Specificity of purpose

The ATO considers the more specific the purpose for which the funds are raised for, the lower the compliance risk. For instance, the ATO considers where the funds are raised for a specific permitted purpose, there will exist a lower compliance risk than where the funds are raised for the general purpose of funding the branch. Where the offer documents state the latter as the purpose, there will be a higher evidentiary burden to prove the funds have not been put to a non-permitted purpose (for at least six months from issue date).

Recycling funds

Throughout the PCG, it is accepted that there may be a change of circumstances that would necessitate funds to be recycled, potentially to a non-permitted purpose. In applying the risk framework to this situation, the Commissioner’s opinion is that recycling funds within six months of issuance will present a medium compliance risk.

Applied for use with related parties

The onlending of funds from the issuing branch to another branch poses a medium compliance risk. Where this occurs, the second branch will need to substantiate the funds are used for a specific permitted purpose or, where they are used for a general purpose, the overall funding position of the branch has not decreased for a six month period after the initial issuance (i.e. to prove there has not been a transfer back to the head office).

Practical considerations

The Commissioner has adopted a more commercial approach throughout the PCG and detailed how he will apply compliance resources to section 215-10 issuances. It is expected, subject to commercial restraints, section 215-10 compliant issuances will recommence. However, aspects of the analysis pose the following administrative concerns:

- At, or prior to, issuance it is common for the issuing bank to seek a private binding ruling on the application of section 215-10. However, throughout the PCG the ATO places significant weight on the use of funds in the six months following issuance. We expect that the ATO should continue to rule on the basis of the expected use of funds and seek to reassess the validity of the ruling should the use of funds change
- While the ATO accepts non-branch personnel will be used to assist with the issuance, the ATO expects that a proportion of their wages should be considered to be incurred in deriving income of the branch and be non-deductible for income tax purposes. As a result, a bank will need to apportion the associated staff’s employment cost between branch and non-branch activities

The ATO has made it clear there will be a high, ongoing compliance burden with 215-10 issuances. Taxpayers should keep appropriate records of the use of funds to substantiate the issuance is low risk.

Internal derivatives and foreign branch profit attribution

The Commissioner extends his permanent establishment attribution approach to certain internal derivative arrangements by multinational banks.

In *Practical Compliance Guideline PCG 2017/8,* the Commissioner outlines the circumstances in which internal derivatives that represent arm's length dealings can be used as an appropriate proxy for the purposes of allocating or attributing a multinational bank's profit to its branch.

When an internal derivative can be used as a proxy under PCG 2017/8 it will have the following consequences:

- For a resident bank, the Commissioner will generally treat amounts appropriately attributed to a branch outside Australia by reference to the internal derivative as being non-assessable non-exempt (**NANE**) income of the resident bank under section 23AH
- For a foreign bank, the Commissioner will treat amounts appropriately attributed to its Australian branch (by reference to the internal derivative) as Australian assessable income.

Profit allocation of multinational bank permanent establishments

The Commissioner's views on the operation of Australia's PE attribution rules to certain funding activities of banks are set out in Taxation Ruling TR 2005/11. This ruling generally supports a relevant business activity (**RBA**) approach rather than the OECD-endorsed functionally separate entity (**FSE**) approach.

Australia hasn't always maintained a consistent approach to profit allocation for PEs of foreign banks by offering an elective modified FSE regime under Part IIIB of the *Income Tax Assessment Act 1936*. This has resulted in the peculiar situation where there is a modified RBA approach for outbound banks and inbound banks that elect out of Part IIIB, while a modified FSE approach is available to inbound banks in Part IIIB.

The Commissioner has softened his approach towards the FSE regime in PCG 2017/8, providing more consistency between the treatment of inbound and outbound banks.

The scope of PCG 2017/8

The guideline applies to both Australian resident banks with foreign branches and foreign banks with Australian branches. The guideline will apply to all internal derivatives (defined as derivatives between a head office and a branch or between two branches) not expressly recognised by

> The guideline takes a risk-based approach and provides extensive guidance through examples to assist a taxpayer in determining whether an arrangement would be considered a low, medium or high complexity scenario.

the income tax laws (i.e. interest rate swaps and forwards, interest rate options, currency swaps forwards and option and derivatives on other asset classes).

The guideline outlines the transfer pricing provisions applicable to inter-branch dealings and reiterates the ATO's views on profit allocation in Taxation Rulings TR 2001/11 and TR 2005/11. It requires banks to undertake:

(a) A functional analysis to determine the functional profile of the entity, and
(b) A comparability analysis to determine the arm's length return for the functions, assets and risks attributed to each part of the bank based on that functional profile.

Therefore, not only must an internal derivative be arm's length in respect to terms and pricing, it must be an arm's length dealing between different parts of the bank as ascertained by a functional and comparability analysis to be accepted as an appropriate proxy.

Important exclusions to the application of PCG 2017/8 include inter-branch arrangements entered into by banks who've elected into Part IIIB or internal derivatives between an offshore banking unit (**OBU**) and its overseas PE. These dealings are already recognised for income tax purposes and subject to the transfer pricing provisions dealing with transactions between separate legal entities.

Some internal derivatives entered into as a part of a highly structured transaction outside the ordinary course of a bank's trading business or internal derivatives the ATO considers cannot be justified based on the functional profile of the branch, also fall outside the scope of PCG 2017/8.

Complexity framework

The guideline takes a risk-based approach and provides extensive guidance through examples to assist a taxpayer in determining whether an arrangement would be considered a low, medium or high complexity scenario. The Commissioner indicates the level of complexity of a transaction should guide the level of analysis a bank should undertake to support the internal derivative as an appropriate proxy in determining attribution of profit. The risk rating will also indicate the extent of compliance resources the ATO allocates to the transaction.

The ruling sets out six indicators of a low complexity scenario, including the ability to show that the internal derivative:

- Relates directly to an unrelated third party derivative transaction
- Has similar/same terms (however not necessarily same pricing)
- Has contemporaneous documentation.

With medium complexity scenarios, it is more difficult to verify the pricing and terms of the internal derivative as there may be no directly matching third party derivative transaction. The internal derivative directly relates only to a part of an actual third party transaction and/or multiple internal derivatives relate to a single third party transaction. In these scenarios, a greater level of analysis is required to support the attribution outcome.

High complexity scenarios are internal derivatives that may reference a third party transaction on materially different terms, be entered into between locations that do not manage that risk or may not reference a third party transaction at all. High complexity scenarios may also include situations where there is no internal derivative, but the risk associated with the third party transactions of a branch is managed in another branch or in the head office. In such situations, the guideline states a transfer pricing adjustment will be required to compensate the branch or the head office that undertakes the risk management functions to ensure proper attribution of profits and allocation of gains/losses from the third party transactions. In all highly complex scenarios, the Commissioner expects a taxpayer should undertake a higher level of analysis and review to justify the profit allocation between branches.

In some highly complex scenarios, it may be difficult for the bank to justify the commerciality of the transaction. In these situations, the use of the internal derivative may not be justified based on the functional profile and it may fall outside the scope of PCG 2017/8.

How does the PCG affect multinational banks practically?

The PCG is a step towards Australia adopting an approach consistent with a FSE approach. The increased consistency between inbound and outbound banks is welcome.

However, based on the examples provided, it appears the ATO will consider the following, relatively routine transactions to be higher risk:

- Internal derivative arrangements adopted by multinational banks in order to hedge credit default risk
- Where a risk of the branch is hedged by way of a central treasury function hedging the net risk of the group, rather than directly hedging each particular risk.

In these circumstances, it would be prudent for taxpayers to have robust contemporaneous transfer pricing documentation in place to support the arm's length nature of the internal derivative and be prepared to substantiate the basis for the particular profit allocation model adopted. Further, the guideline reiterates that the Commissioner expects banks will prepare and maintain sufficient documentation as outlined in Subdivision 284-E of the *Taxation Administration Act 1953* and Taxation Ruling TR 2014/8. In the event the Commissioner makes a transfer pricing adjustment and the documentation requirement is not satisfied, the Commissioner will treat the transfer pricing position adopted by the bank as not being reasonably arguable for penalty purposes

Reflections on *Chevron*

Implications for the banking sector.

On 21 April 2017, the Full Federal Court (**FFC**) handed down a decision in favour of the ATO in Australia's first transfer pricing court case on financing. The decision is currently under appeal. Whilst having broader significance, this is especially significant for the banking industry, given related party debt and associated capital management transactions are some of the most important transfer pricing issues faced by banks.

The case involved a credit facility extended to Chevron Australia Holdings Pty Ltd (**CAHPL**) by a US resident subsidiary of CAHPL. The US subsidiary had borrowed US dollar funds (AU$2.5 billion equivalent) from the commercial paper market at an interest rate of around 1.2%, with the benefit of a guarantee from the ultimate parent company, Chevron Corporation. It on-lent the funds to CAHPL at AUD LIBOR + 4.14% (which equated to around 9% in the period under review). This interest rate was based on a stand-alone credit rating of CAHPL and transfer pricing analysis using the actual terms and conditions of the facility.

The ATO issued CAHPL with transfer pricing assessments on the basis the interest rate on the loans was in excess of an arm's length rate. The case involved approximately AU$340 million in tax and penalties covering the 2004-08 period.

In addition to the substantive interest rate issue, the FFC also considered a number of procedural and legal matters, including:

- Whether the determinations under Division 815-A (which has retrospective effect to income years on or 30 June 2004) were constitutionally valid
- The impact of the fact that the ATO officer, who made the assessments, was not properly authorised.

The FFC upheld the trial judge decision that CAHPL had not shown that the interest paid under the credit facility agreement was equal to or less than arm's length. As the onus of proof was on CAHPL to prove that the ATO's assessments under Division 13 were excessive, the ATO did not have to argue every technical aspect of its assessments.

The decision will no doubt embolden the ATO, particularly in respect of other financing audit cases which are currently underway, and in targeting new cases for audit.

In detail

The key points of the judgement are as follows:

- Relevantly in the post BEPS environment, the judgment affirmed the role of the transfer pricing provisions in providing the ATO with broad powers to substitute a more commercially realistic transaction where the actual transaction is considered to be, in whole or part, one that could not occur in the open market

- The legal defects in the making of the ATO's determinations did not affect the validity of the assessment and did not assist the taxpayer in seeking to set those assessments aside. The decision reaffirmed the critical burden of proof in tax cases which rests with the taxpayer and the Court's willingness to determine matters in a way that is fair, without unduly relying on administrative technicalities
- The FFC confirmed the decision of the trial judge in holding that the arm's length inquiry retains the context and reality of a multinational group (i.e. rejection of the "orphan theory"). In addition, the FFC found there was no reason to depart from the trial judge's view that an independent borrower like CAHPL, dealing at arm's length, would have given security and operational and financial covenants to acquire the loan, which would have resulted in a lower interest rate. This is particularly relevant for situations where no senior secured debt is in place in addition to related party debt arrangements
- Consideration should be given to the availability of an explicit parental guarantee being obtained by the borrower in a related party financing transaction. Where such a guarantee may be available, the interest rate would be expected to be lower; and if not available, the taxpayer should be in a position to explain why not. It is therefore possible in future cases courts may be persuaded by parental guarantee arguments advanced by either taxpayers or the ATO
- Both the trial judge and the FFC considered whether the loan would have been in fact a US dollar loan, although the loan agreement was denominated in Australian dollars. Ultimately, however, the FFC saw no reason to depart from the conclusion of the trial judge that the hypothetical agreement might reasonably have been expected to be in Australian dollars
- In summary, the FFC rejected an approach to transfer pricing which involved working out accurate pricing for the transaction which actually occurred. Instead, it suggested that the law allowed the ATO to substitute a transaction which reflected how a company in the taxpayer's position would achieve the same commercial aims in an arm's length transaction. Accordingly, evidence about the taxpayer's usual commercial practices (or lack of such evidence) was central to key parts of the decision.

Impact

The decision will no doubt embolden the ATO, particularly in respect of other financing audit cases which are currently underway, and in targeting new cases for audit. Senior ATO leadership has described intra-group financing as the number one risk it is focused on with regard to multinational taxation.

While it is clear the decision will have significant implications in applying transfer pricing provisions to financing transactions, the principles espoused by the judges and the approach to the interpretation of the transfer pricing provisions may have ramifications for intra-group transactions generally, such as charges for services within a multinational group and the commerciality overlay on intercompany contracts. That is, the arm's length principle is more than the simple pricing of a given transaction (given the actual terms and conditions), but rather also encompasses the question of whether an independent party, acting in its own best interests, would have entered into a transaction on those terms and conditions. The commerciality overlay and mindset applied by the FFC is consistent with the current OECD view in the BEPS Actions, and as such, this decision could be considered a post BEPS decision and may be indicative of how future courts may consider financing where the OECD Guidelines have relevance to local transfer pricing legislation.

Further, although the decision concerns Division 13 and Subdivision 815-A, it is consistent with the outcome that might be reached under Australia's new transfer pricing laws. Subdivision 815-B, which applies for income years after 30 June 2013, contains what are referred to as the 'reconstruction powers' and are explicitly linked to the OECD Guidelines. While the FFC was unclear on the extent Division 13 allowed for reconstruction of the actual terms and conditions of the loan, it nonetheless reached the view that CAHPL, if it had been acting independently and dealing with a third party lender, would have been expected to have given security and operational and financial covenants to acquire the loan. The FFC relied on the evidence of two expert witnesses, ironically provided by Chevron, who testified that a loan of a comparable size in the oil and gas sector would not have been made by an independent lender in the absence of such requirements.

A critical component of the FFC's conclusion was that a subsidiary, from a pricing perspective, should not be viewed as an 'orphan' from the multinational group. That is, it should be viewed as it is, as part of a larger group and having its credit characteristics potentially influenced by its association with that larger group. This is consistent with the new OECD Guidance in Chapter 1 of the BEPS Actions 8-10 report. Further, in the application of the 'arm's length debt test', Australia's thin capitalisation provisions (Division 820) specifically require all connections of the Australian taxpayer with the multinational group be ignored. It seems this approach provides the worst possible combination for taxpayers regarding their allowable debt deductions, with the arm's length amount of debt (above the thin capitalisation 'safe harbour') set without reference to the wider group, but the arm's length price of the debt required to be set with regard to the wider group. This appears to be a possible inconsistency in policy rationale, which will need to be monitored.

The importance of internal agreements and group policies is also highlighted in this case. The rights and obligations conferred in the credit facility agreement, the Chevron group's internal policies and its decision making processes regarding financing arrangements were taken into account by the FFC in reaching its decision as to an arm's length arrangement that might have been entered into by CAHPL.

Action

Subject to appeal, the decision provides the first substantive judicial guidance in Australia on the difficult territory of establishing arm's length arrangements between related parties.

Banks which have, or are contemplating, intra-group arrangements need to demonstrate the commercial context of the intercompany arrangement, including bringing forth evidence supporting this. This review may cover:

- The appropriate "commercial" mix of debt including tenor profiles and interaction with regulatory considerations
- The commerciality of the terms (e.g. security, covenants, guarantees, tenor and currency) as well as the pricing of all intra-group arrangements
- Alternative related party arrangements which were considered (and reasons for rejection, if appropriate)
- The role of financing companies/vehicles in the group structure

- In relation to inbound intra-group financing arrangements, existing group policies on financing and parental security, as well as any gap between the parent's/group's cost of funding and the interest rate charged to the Australian operations (assuming the Australian taxpayer is not within Part IIIB of the *Income Tax Assessment Act 1936*).

This is particularly pertinent for banks, or finance companies that are part of a banking group. The cost of funding for a multinational banking group is generally publicly available, and the parent/main operating entity in such a group would typically have significant capital reserves and enjoy a strong credit rating, which would further widen the gap between the parent's/group's cost of funding and that of its subsidiary on a stand-alone basis.

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In the FFC decision, there was no guidance on the issue of parental affiliation (i.e. the concept that a third party lender would take into account the wider group affiliation when assessing the creditworthiness of a subsidiary, and where no explicit guarantee is provided). Although the trial judge accepted CAHPL's submission that parental affiliation had "little if any impact on pricing by a lender" in the case, he was not wholly dismissive of the concept. Given the importance of reputation and perceptions of credit strength in the banking industry, and acceptance of the parental affiliation concept in the Canadian transfer pricing case of GE Capital, it is possible the ATO or a court would consider that a parent company would not allow an offshore subsidiary to default on a loan, and this implicit support should be taken into account in analysing the credit strength of the subsidiary in the financial services sector on an arm's length basis.

To gain an understanding of what independent lenders would do in auditing intra-group financing activities, the ATO had also sought information from banks on their credit rating processes and approach to pricing large loans, i.e. above AU$1 billion. Banks may need to consider how such information may be availed or used as part of the ATO's compliance activities.

In summary, we recommend banks review both historic and prospective related party arrangements in light of the decision. This would include a review of all intercompany arrangements and legal agreements, background information and documentation, as well as discussions with the bank's Treasury team and credit analysts where appropriate. This will ensure all relevant information is considered in reviewing and potentially defending positions taken in the event of an ATO review, and assessing the need to restructure arrangements, or to seek certainty from the ATO via an Advance Pricing Arrangement.

CAHPL has applied for special leave to appeal to the High Court. Taxpayers should therefore monitor any High Court decision on this case in the coming months.

CRS – are you ready?

The common reporting standard (**CRS**) commences for Australian financial institutions from 1 July 2017.

Over 100 jurisdictions, including Australia, have committed to implement CRS, the global standard for the collection and reporting of information on financial accounts held by foreign tax residents. The CRS has been implemented into Australian legislation and will impact onboarding, due diligence and reporting procedures for Australian financial institutions (**FIs**). The ATO has published Automatic Exchange of Information (**AEOI**) guidance material to assist Australian FIs comply with both FATCA and CRS from 1 July 2017 and it updates this guidance as it continues to undertake consultation with industry.

Australian FIs are required to classify their group's entities which will determine their CRS obligations. Entities classified as Reporting FIs (**RFIs**) need to review their financial accounts and determine which of those accounts and associated account holder data must be collected and reported to the ATO. Australian FIs need to begin collecting information from new account holders from 1 July 2017, with the first CRS report due to the ATO by 31 July 2018 for the period 1 July to 31 December 2017. FIs must also complete pre-existing entity and high value individual account due diligence by 31 July 2018 and low value individual account due diligence by 31 July 2019.

The scale and complexity of CRS, combined with a rapidly approaching deadline, provides a challenging scenario for Australian FIs. Current FATCA procedures and processes can be leveraged in implementing CRS. However, there are differences between the two regimes in key operational and regulatory aspects. Additionally, each of the 100 participating jurisdictions is implementing customised timelines and requirements that will impact FIs with a global footprint.

Given the 1 July start date, Australian FIs need to focus on new account onboarding for in scope entities and accounts as a priority, followed by pre-existing account due diligence and reporting.

Reporting FIs resident in other jurisdictions are likely to have different due diligence requirements and deadlines. For many participating jurisdictions, CRS started in 2016, so foreign reporting FIs may have reporting obligations for the 2016 calendar year and due diligence timelines may have already passed.

CRS new account onboarding due diligence

Australian RFIs must collect a self-certification upon account opening from new account holders on or after 1 July 2017 to identify if they are a foreign tax resident or an entity with foreign controlling persons. A self-certification is generally considered valid if it includes the account holder name, residence address, tax jurisdiction, Tax Identification Number (**TIN**), date of birth (if an individual) and is signed or positively confirmed by the account holder. There is no standard self-certification form, although some tax authorities and industry groups have released templates.

An account that is held by a passive non-financial entity (**NFE**) must provide self-certifications for any non-resident controlling persons. In some instances, RFIs may rely on AML/KYC documentation and other information, instead of a self-certification, to determine if an entity account holder is an active NFE or FI.

The FI is required to review the self-certification for completeness and reasonableness, determining whether the FI has information contradicting the self-certification.

CRS onboarding procedures can be complex and varied and the CRS requirements are subject to exceptions and complexities that may require business decisions. Many financial institutions seek to modify FATCA onboarding procedures to also include CRS.

CRS due diligence procedures for pre-existing entity and high value individual accounts

Similar to FATCA, CRS breaks down pre-existing due diligence requirements by low value individual accounts, high value individual accounts and entity accounts. Australian FIs are required to complete pre-existing due diligence on high value individual and entity accounts by 31 July 2018.

For high value individual accounts (value over $1m), FIs must undertake an electronic records search for indicia of the individual's tax residence. The indicia are as follows:

- Resident of a foreign jurisdiction
- Mailing or residence address of the account holder in a foreign jurisdiction
- One or more current telephone numbers in a foreign jurisdiction with no telephone number in Australia
- Current standing instructions to transfer funds to an account maintained in a foreign jurisdiction (for non-depository accounts)
- Current power of attorney or signatory authority granted to a person in a foreign jurisdiction
- An 'in care of' address or 'hold mail' instruction in a foreign jurisdiction and no other address on file for the account holder.

If the FI's electronic systems do not contain all of these data fields then a paper search is required to find information for the data fields not available electronically.

High value individual accounts are also required to make a relationship manger inquiry for actual knowledge as to whether the account holder is a reportable person.

The individual will be considered resident of a foreign jurisdiction if indicia are found and are not cured.

Entity accounts with an account value over $250,000 must also be reviewed. FIs can disregard the threshold and apply the due diligence procedures to all entity account holders. If the threshold is applied, the account must be reviewed if it later exceeds $250,000.

Entity accounts must be reviewed for foreign indicia, including:

- Incorporation or organisation in a foreign jurisdiction
- Address in a foreign jurisdiction.

CRS onboarding and due diligence procedures can be complex and varied and the CRS requirements are subject to choices, exceptions and complexities that may require business decisions.

The FI can also review AML/KYC information and publicly available information to determine certain classifications of entity accounts.

If foreign indicia is found, the account holder is reportable unless the indicia can be cured.

If the FI determines that the entity is a Passive NFE, the FI must identify the controlling persons of the entity and whether those controlling persons are foreign tax residents.

As Australia has adopted the 'wider approach', Australian FIs may face operational challenges in effectively identifying the tax residency of all in-scope account holders within the designated timeframes. Australian RFIs should prepare to start their CRS pre-existing account due diligence efforts from 1 July 2017.

Interaction of pre-existing account due diligence and reporting deadlines

Generally, an account identified as reportable during a calendar year is reportable for that year. For example, an account identified as reportable in February 2018 would be included in the 2018 calendar year report to be lodged by 31 July 2019.

However, pre-existing high value individual accounts and pre-existing entity accounts identified as reportable are exceptions to this general rule. Due diligence on pre-existing high value individual accounts and pre-existing entity accounts is required to be undertaken between 1 July 2017 and 31 July 2018. If accounts are identified as reportable on/after 1 January 2018, they are to be included in the report for the period 1 July 2017 to 31 December 2017, due 31 July 2018.

The impact of these exceptions is that the population of reportable accounts for the 2017 CRS report may continue to change up to 31 July 2018, making it difficult to prepare and lodge the CRS report by 31 July 2018. Accordingly, Australian RFIs may choose to complete due diligence on pre-existing high value individual accounts and pre-existing entity accounts by a date prior to 31 July 2018 (e.g. 31 May 2018), so that the population of reportable accounts can be finalised with enough time to prepare and lodge the 2017 report by 31 July 2018.

Action

While the current focus is on being ready for new account onboarding requirements from 1 July 2017, Australian FIs will need to quickly turn their attention to due diligence on pre-existing accounts, particularly for high value individual accounts and pre-existing entity accounts which is required to be completed by 31 July 2018.

Retail premiums – ATO accepts industry practice for renounceable rights issuances

Uncertainty regarding the income tax treatment of retail premiums under renounceable rights issuances appears to be resolved with the ATO following industry practice in TR 2017/D3 *Income tax: taxation of rights and retail premiums under renounceable rights offers where shares held on capital account.*

Renounceable rights issuances

If finalised, draft Taxation Ruling TR 2017/D3 will apply to renounceable rights offers made to Australian resident eligible shareholders and foreign resident ineligible shareholders who hold their shares on capital account. Unlike the treatment of non-renounceable rights offers in Taxation Ruling TR 2012/1, the Commissioner has indicated that he will treat renounceable rights issuances in the following way:

- The retail premium is not an amount that is credited to the company's share capital account. Rather, it represents the amount received in excess of the offer price under the retail bookbuild. Accordingly, the ATO accepts this amount is referrable to proceeds for the sale of the rights issue entitlement, is not a distribution from the company and is, therefore, not a dividend.
- For eligible shareholders, the premium represents capital proceeds for the realisation of a CGT asset (being the entitlement to participate in the offer). As the entitlement to participate is issued for nil consideration, shareholders do not have a cost base in the entitlement. Accordingly, they make a capital gain equal to the retail premium received (subject to any applicable CGT discount if they have held their original shares for at least 12 months)
- For ineligible shareholders, CGT event C2 occurs when they receive the retail premium. Where the associated share is not taxable Australian real property, non-residents will not have an Australian income tax liability

- The retail premium is not ordinary income. Accordingly, as the retail premium is not a dividend or ordinary income the anti-overlap provisions do not operate.

This is a favourable divergence from the Commissioner's treatment of non-renounceable rights offers. This treatment provides shareholders a better result with resident shareholders able to treat the premium as a capital gain (and potentially access the CGT discount) and non-resident shareholders generally receiving the retail premium free from Australian tax.

The brevity of the ATO's explanation in TR 2017/D3 may be telling of the tenuous technical basis for a different outcome between renounceable and non-renounceable right issuances.

Non-renounceable rights issuances

In TR 2012/1 *Income tax: retail premiums paid to shareholders where share entitlements are not taken up or are not available* (basically, a non-renounceable rights issue) the ATO took the controversial position that:

- The retail premium represents a distribution from the company's share capital that was sourced directly from a third party's subscription to the same share capital account. As such, the general exclusion from the dividend definition for amounts sourced from a share capital account does not apply and the amount is taken to be a dividend for income tax purposes
- The deeming provision in subsection 44(1B) applies to ensure that the dividend is assessable income of the recipient by treating the amount to be paid out of profits
- The franking integrity provision in paragraph 202-45(e) applies to deem the distribution to be an unfrankable distribution. As such, where the recipient is a non-resident, the issuing company will need to withhold from the retail premium at the appropriate dividend withholding rate
- For ineligible shareholders (generally foreign shareholders who are not entitled to participate in the rights issue and instead have their rights sold through a retail bookbuild) the right to receive a retail premium is a CGT asset that comes to an end when they receive the retail premium. Accordingly, CGT even C2 will happen. However, the anti-overlap provisions will operate to reduce any gain by the amount considered to be a dividend
- In the alternative, the retail premium is ordinary income.

This was not a desirable outcome for either the shareholders or the issuing company and led to an increase in renounceable rights issuances. Industry took the position that the renounceable rights issuances could be distinguished from non-renounceable rights issuances such that TR 2012/1 did not apply.

Distinguishing points

	Ruling	Dividend	WHT	CGT
Renounceable	TR 2017/D3	No	No	Yes
Non-renounceable	TR 2012/1	Yes*	Yes	Yes**

*If a retail premium paid to a non-participating shareholder is not a dividend, then the ATO would consider it ordinary income in the alternative.

**Any capital will be reduced by virtue of the anti-overlap provisions.

The brevity of the ATO’s explanation in TR 2017/D3 may be telling of the tenuous technical basis for a different outcome between renounceable and non-renounceable right issuances.

In coming to a conclusion a retail premium was a dividend in TR 2012/1, the ATO discusses at length that even in situations where the lead manager or other agent withholds the retail premium such that it is never credited to the company, it would still be regarded as having been paid at the direction of the company.

However, in TR 2017/D3, the ATO briefly concludes that such payments are not distributions by the company, but are instead proceeds from the disposal of the rights issue entitlement.

It would appear as though the ATO is departing from its somewhat controversial views in TR 2012/1. The departure is expected to be welcomed by industry and shareholders.

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