Australian Government

The Board of Taxation

APPLICATION OF HYBRID MISMATCH RULES TO REGULATORY CAPITAL

A Report to the Treasurer

the board of taxation
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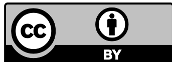

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FOREWORD

The Board of Taxation (the Board) is pleased to submit this report to the Treasurer following its review of the application of hybrid mismatch rules to regulatory capital in Australia.

This report explores the complex interaction between existing and future taxation and regulatory policy settings for Additional Tier 1 capital instruments (AT1), which may form part of the regulatory capital required to be issued by 'regulated entities' and which have mandated terms under the prudential standards issued by the Australian Prudential Regulation Authority (APRA).

The Board has made 9 recommendations.

The Board appointed Karen Payne to oversee the review. The Board also appointed a Working Group consisting of officials from the Treasury and the Australian Taxation Office (ATO).

The Working Group held discussions and targeted consultation meetings with a range of stakeholders in the banking and insurance sectors (including external and in-house tax advisers and treasury functions). The Working Group also consulted with APRA, the Australian Accounting Standards Board (AASB), the Organisation for Economic Co-operation and Development (OECD), with the New Zealand Inland Revenue Department (NZ IRD) and with the United Kingdom's Her Majesty's Revenue and Customs (HMRC).

The *ex officio* members of the Board — the Secretary to the Treasury, John Fraser, the Commissioner of Taxation, Chris Jordan AO, and the First Parliamentary Counsel, Peter Quiggin PSM — have reserved their final views on the observations and recommendations in this report for advice to Government.

The Board would like to thank all of those who so readily contributed information and time to assist in conducting the review.

Michael Andrew AO
Chair, Board of Taxation

Karen Payne
Chair of the Board's Working Group
Member/CEO, Board of Taxation

OVERVIEW

APRA requires regulated entities, such as banks and insurers, to raise minimum levels of capital within a prudential framework that specifies mandated terms for various tiers of capital. One tier below Common Equity Tier 1 (CET1) is AT1. AT1 are hybrid instruments because they are typically legal form notes that include both debt features[1] and equity features.[2]

Commercially, AT1 operate like debt, with a fixed rate of return, an expectation of being repaid the face value of the instrument (although the issuer has no such repayment obligation),[3] no profit participation and no voting rights. However, Australia's debt/equity tax rules contain a bright line test which, notwithstanding the market's view of these instruments as fixed income securities, categorises AT1 as equity for tax purposes. This categorisation arises partly due to certain regulatory requirements in the terms of these instruments to ensure they can be converted to higher quality CET1 capital, including in a crisis situation.

Whereas AT1 are treated as equity for tax purposes in Australia (and therefore returns on the instruments are frankable), they are treated as debt for tax purposes in many other overseas jurisdictions (and returns on the instruments are therefore deductible in those jurisdictions). This can give rise to a tax hybrid mismatch, where Australian regulated entities issue AT1 (largely to domestic investors) through an offshore branch in one of these jurisdictions (typically New Zealand (NZ) or the United Kingdom (UK)). The mismatch arises as the returns on the AT1 are frankable (such that Australian investors receive tax relief in the form of a franking credit) but are also deductible to the regulated entity. As at 30 June 2016, around a fifth ($A7.3 billion) of all AT1 raised by Australian regulated entities is raised in this tax hybrid form.

Section 215-10 of the 1997 Act provides an exception to the general rule that distributions on equity interests must be franked. It applies to switch off the requirement to frank non-share dividends paid by Australian resident ADIs on legal form debt forming part of the ADI's Tier 1 capital that is classified as equity under Australia's tax debt/equity rules. The exception to the franking obligation arises, broadly, when the equity interests are issued at or through a foreign branch of an ADI

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1 Some notable 'debt-like' features are a fixed rate of return (albeit discretionary), no profit participation above the fixed return and the instruments may be redeemed or converted into a variable number of ordinary shares. Historically, with few exceptions, investors have received at least the face value of the instrument back by way of redemption. This may be re-invested into new instruments at the time of redemption.

2 Some notable equity features are that they are legal form perpetual instruments, the payment of the return is discretionary and at the option of the issuer, the instrument may convert into ordinary shares at the option of the issuer or APRA.

3 Repayment of face value is discretionary and, the issuer must not create an expectation at issuance that the instrument will be bought back, redeemed or cancelled. See *Prudential Standard APS 111, Attachment E, paragraph 1(e)*.

in a listed country to raise funds for use in the foreign branch business. The section 215-10 concession does not extend to all regulated entities, such as insurers.

The Board examined a number of options to neutralise regulatory capital hybrid mismatch arrangements, having regard to the terms of reference for this project. These included:

- **Option A** — to make returns on AT1 unfrankable in certain circumstances. The Board looked at a number of variations of circumstances where the returns could be treated as unfrankable as set out below:

  (a) where the return is deductible in a foreign jurisdiction (Option A1);

  (b) where the return is deductible in a foreign jurisdiction, but the unfrankable treatment is capped (for example, to a fixed percentage of AT1) (Option A2);

  (c) where the return is deductible in a foreign jurisdiction, but only where the conditions in section 215-10 are met. Where the conditions in section 215-10 are not met, a debit to the franking account would occur (Option A3); or

  (d) where the return is deductible in a foreign jurisdiction or where the AT1 is issued out of a foreign branch (regardless of section 215-10 or whether a deduction has been claimed in the foreign jurisdiction) (Option A4).

- **Option B** — to make returns on AT1 deductible and unfrankable in Australia. The Board looked at two variations within this category:

  (a) AT1 have debt treatment in Australia and returns are deductible but not frankable - consistent with the debt treatment in most overseas jurisdictions (Option B1);

  (b) allow taxpayers to choose to issue AT1 as tax debt (with returns deductible/unfrankable) or tax equity (with non-deductible/frankable), which could be subject to a capping mechanism to limit debt issuances (Option B2).

- **Option C** — to carve regulatory capital out of the scope of the hybrid mismatch rules (consistent with the approach taken in the UK) and instead rely on the foreign jurisdiction's hybrid mismatch rules to neutralise the hybrid mismatch outcome.

In effect, options A1-3 neutralise the hybrid mismatch by requiring alignment of Australia's tax treatment for the returns with the debt tax treatment of the foreign jurisdiction in which a deduction has been claimed for those returns. The treatment is bifurcated depending where the funds are attributed (which may determine where a foreign deduction is claimed) — that is, AT1 issued through, or used in, a foreign branch is attributed to that branch and treated as tax debt (and is therefore unfrankable), whereas AT1 attributed to an Australian entity in Australia remains tax equity (and is therefore frankable). Option A4 goes further than Options A1-3 by treating returns on the instrument as unfrankable where the AT1 is issued outside of Australia (regardless of the foreign tax treatment). This removes any requirement to trace the use of the funds – which is difficult to evidence commercially and administer by the ATO.

Option B does not have this bifurcation, and instead treats all AT1 as debt for Australian tax purposes regardless of the place of issue, use or attribution. This option therefore has broader implications for the tax treatment of regulatory capital than just the neutralisation of cross-border hybrid mismatches.

Treatment of AT1 as unfrankable under either option is expected to result in certain behavioural consequences — refer to section 4.5. This includes an increase in issuances to foreign and domestic institutional investors, thus diversifying the investor base for AT1 away from Australian domestic retail investors. This is because the removal of the requirement to frank means commercially, issuances can be made on a gross pay basis (with the full return paid as cash, rather than reduced for any franking credit benefit). Most of the 'A' options facilitate this only where AT1 is raised through the foreign branch. Option B allows additional flexibility to raise from either the branch or the parent, but there is an expectation that commercially most will be raised from the parent due to Australia's lower costs of issuance and higher corporate tax rate (currently 30 per cent), which increases the value of the deduction.

Executive Summary

Each of the options considered by the Board has the potential to neutralise hybrid mismatch arrangements, consistent with Australia's commitment to implement the OECD BEPS recommendations. The terms of reference for the Board (as set out in Appendix A) are broader than international taxation considerations and require an examination of a number of regulatory, market, economic and competition factors.

The Board assessed each of the options against the terms of reference (refer Appendices A and D) and supports options which provide the greatest benefit from a whole of system perspective (consistent with the terms of reference). The Board also considers preference should be given to tax policies which least inhibit the way an entity carries on its business commercially.

The Board identified through its consultation process that some features of the current tax system can alter the manner in which a regulated entity might otherwise raise capital or undertake its commercial activities. The tax equity classification and resultant ability or requirement to frank AT1 has led to a bias towards issuances to the Australian domestic retail market. This can put additional pressure on the financial system as a whole, as in times of crisis a wholly domestic retail market would be required to bear losses. Further, tax settings which encourage a concentrated domestic investor base have the potential to limit the ability for regulated institutions to raise funding from otherwise favourable international markets. Further, some ADIs are able to fund returns on AT1 at a lower cash cost of financing (using deductible/frankable AT1) relative to other ADIs, which gives rise to competition issues.

Behavioural implications of policy changes

The Board has also noted in this report some general observations, again from the consultation process, on how the market may respond to the various policy options, which may have flow on impacts to the cost to revenue. In particular, the Board notes that a switch from (franked) equity to (unfranked) debt treatment within a particular tax rate class should be neutral at the investor level for domestic investors. However, policy options which encourage diversification of funding sources (under either Options A and B) may result in a higher number of foreign investors (who are not subject to tax on the AT1 returns received) or a shift from higher rate taxpayers to lower rate institutional taxpayers[4] investing into AT1.

4 Including self-managed and retail superannuation funds which benefit from a refund of franking credits.

RECOMMENDATION

The Board recommends a change in law to facilitate treatment of AT1 as debt for tax purposes (Option B1).

Option B1 – treat AT1 as debt for tax purposes

The Board recommends Option B1, as it brings broader regulatory, market, economic and competition benefits, beyond just neutralising deductible/frankable hybrid mismatches.

Under this option, AT1 is treated as debt for tax purposes in Australia, such that returns are deductible but not frankable.

This is the only option which appears to meet all of the factors noted in the terms of reference. In particular, Option B1 delivers the following benefits:

- it removes tax considerations and constraints from the capital raising decision, which allows all regulated entities to:
  - access alternative capital markets (in whichever market is cheapest);
  - raise capital from a diversified investor base, thereby reducing financial system risk;
- it encourages AT1 to be issued by the Australian parent rather than through an offshore branch, which may:
  - encourage Australian regulated entities to carry on business and make profits in Australia (which are then taxable in Australia rather than the foreign jurisdiction); and
  - reduce resolution risk (ability of foreign regulators to seize offshore assets) in the event of a banking crisis.
- it aligns Australia's tax treatment with most other international jurisdictions (like the UK, Japan and NZ), which treat AT1 as debt (it is worth noting that Hong Kong, Singapore and Ireland also changed their tax treatment of AT1 to debt recently to support their financial sector competing in international markets for funding);
- it provides a level playing field internationally, as all Australian regulated entities can compete for international capital on equal terms to their foreign counterparts (as noted above, most other jurisdictions treat AT1 as debt for tax purposes);
- it provides a level playing field domestically as all regulated entities have equal tax settings, and therefore wholly domestic regional banks and insurers are not disadvantaged relative to the major banks and insurers with offshore operations;

- it is simple to comply with and administer; and
- it also likely aligns the tax and accounting treatment of AT1, which can remove adverse accounting outcomes arising from a misalignment.

However, Option B1 has the following outcomes:

- it involves a broader departure from existing tax settings than Option A and, arguably, it may be more difficult to predict (with certainty) any market and behavioural responses and consequences;
- it goes beyond neutralising hybrid mismatch arrangements (more so than the 'A' options) to change the tax treatment of all AT1, not just AT1 issued from an offshore branch; and
- it requires a departure from the existing bright line debt/equity tax rules.

Debt treatment of AT1 could be achieved by way of introducing regulations, similar to the approach taken for Tier 2 regulatory capital in 2010, 2011 and 2012 (which facilitate debt tax treatment for Tier 2 issuances by ignoring certain equity like regulatory features when applying the debt/equity tax rules).

The Board notes that there is a cap on the amount of AT1 that can be included as regulatory capital (currently 1.5% of risk weighted assets) and therefore existing regulatory and natural commercial constraints,[5] as well as tax constraints,[6] should operate to prevent excessive AT1 issuances or deductions if given debt treatment.

It should also be noted that commercially AT1 operate like fixed income securities, with regular (albeit discretionary) interest payments based on a fixed margin over the Bank Bill Swap Rate. Where the AT1 is frankable, the interest yield (which is set according to the market at the time) will typically be provided to the investor as 70 per cent cash, with the remaining 30 per cent of value provided as a franking credit. Where the investor does not receive a franking credit benefit (due to a shortfall) under the terms of the instrument they will instead receive a 30 percentage point higher return in cash (that is, if the return is not frankable, the investors will receive all (100 per cent) of the yield in cash). Likewise, if the instrument is unfrankable, the investor will receive the full yield (as set by the market) in cash.

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5 Even if granted debt treatment, AT1 is generally expected to be more expensive to issue than other deductible forms of debt capital due to its higher risk profile.

6 For example, thin capitalisation.

Because of this, changing the tax treatment of AT1 from equity to debt should be broadly neutral from a cash perspective for both the regulated entities and domestic investors.[7] Therefore, one of the main benefits under Option B1 is the removal of tax constraints for regulated entities affecting their ability to access alternative capital markets, rather than any additional cash benefit for the regulated entity from being able to claim a deduction on AT1 returns. Regulated entities may also receive a benefit to their accounting profit from debt tax treatment by aligning the accounting and tax classification of these instruments.

OTHER OPTIONS CONSIDERED

The Board's recommendation has been made with the benefit of a costing analysis undertaken by Treasury. The costing outcomes depend on the assumptions made, and the Board has included some observations on potential behavioural responses in this report to help guide those assumptions. However, the actual behavioural responses will depend on how regulated entities respond in their capital raising decisions and on external market factors (which are difficult to predict).

The Board is cognisant that some of the options considered are expected to have a cost to revenue relative to each other and to the existing law, and this will be a further factor in the process of the Government weighing up the benefits and detriments of each approach. Accordingly, the Board has noted some alternate approaches in this report (at paragraphs 4.2.30 - 4.2.35) should the Government consider the Board's preferred option is not possible at this time. However, the alternative approaches are unlikely to achieve the same level of market and financial system benefits as Option B1.

CONCLUSION

The Board acknowledges that there may be some sensitivities associated with each of the options to neutralise hybrid mismatch arrangements. Notwithstanding the potential for different perceptions or sensitivities about these options, the Board does not consider these concerns to be a sufficient reason to not recommend options which provide optimal benefits. Option B1 (to make returns on AT1 deductible in Australia) delivers a solution which neutralises the hybrid mismatch and provides benefits consistent with all of the terms of reference.

In the Board's view, the additional benefits (including those noted at paragraphs 1.3.10 and 4.3.18) to the Australian economy and contribution to the stability of the financial system should outweigh any tax considerations.

7 That is, the cash tax benefit of the deduction claimable by the regulated entity is neutralised by the 30% higher gross return paid to the investor for an unfranked instrument. Likewise for the investor, the higher gross return received should cover any additional tax burden from the loss of a franking credit. Refer to Table 5 in this report for further.

The Board notes that there will need to be transitional arrangements for existing regulatory capital and accordingly has made recommendations to deal with transition, which it ultimately considers can be managed without material market disruption. In particular, to prevent market disruption, the Board recommends grandfathering of existing AT1 issuances from application of any hybrid mismatch measures to eliminate deductible/frankable arrangements. It also recommends grandfathering of the current tax treatment for existing AT1 issues should the Government proceed with the adoption of Option B1.

A summary of the key recommendations made in this report regarding the application of hybrid mismatch rules to regulatory capital in Australia is set out in Appendix C.

Chapter 1: Introduction

1.1 Background

1.1.1 On 12 May 2015, the Treasurer asked the Board to consult on the implementation of hybrid mismatch rules as developed by the OECD under Action 2 of the Base Erosion and Profit Shifting (BEPS) Action Plan — *Neutralising the Effects of Hybrid Mismatch Arrangements* (Action 2 Report). The Board submitted its Report *'Implementation of the OECD Hybrid Mismatch Rules'* to the Treasurer on 31 March 2016 ('Hybrid Mismatch Report'), making 17 recommendations on Australia's implementation of the OECD hybrid mismatch rules.

1.1.2 The Board's Hybrid Mismatch Report recommended further work to consider the appropriate policy response in relation to neutralising hybrid mismatches for regulatory capital hybrid instruments.

1.1.3 The Government agreed to the Board's recommendation and on 8 April 2016, the Treasurer issued the Board with further terms of reference (as attached at Appendix A).

1.1.4 The terms note that in determining how best to neutralise the hybrid mismatch arrangement involving regulatory capital, the Board should identify an implementation strategy that has regard to:

(a) delivering on the objectives of eliminating double non-taxation;

(b) capital regulatory requirements as enforced and set by the Australian Prudential Regulation Authority;

(c) fostering a level playing field internationally and within the Australian banking and insurance sector;

(d) economic implications and potential market disruption;

(e) compliance and administrative costs for taxpayers; and

(f) interactions between Australia's existing domestic legislation, including with related tax laws.

1.2 REVIEW PROCESS

Consultation

1.2.1 The Board's consultation process has involved:

- consultation with APRA to understand Australia's prudential framework and its views on taxation considerations impacting on capital raising decision-making;
- consultation with the OECD to understand the regulatory capital considerations raised in the context of the Action 2 Report;
- consultation with the NZ IRD and UK HMRC to understand their proposed application of hybrid mismatch rules to regulatory capital;
- consultation sessions with invited participants from regulated entities in the banking and insurance sectors;
- consultation with the AASB in relation to the accounting classification of regulatory capital;
- consultation with one of the ratings agencies;
- consultation with a panel of invitees from Australian accounting firms, legal firms and academics; and
- completion of survey responses by regulated entities in the banking and insurance sectors.

Board's report

1.2.2 The Board considered the comments and submissions from stakeholders at the consultation meetings and the views of the members of the Working Group[8], Treasury and the ATO. However, the Board's recommendations reflect its independent judgment.

1.2.3 All legislative references in this Report are a reference to either the *Income Tax Assessment Act 1936* (1936 Act) or the *Income Tax Assessment Act 1997* (1997 Act), unless otherwise stated.

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8 As the Government was in caretaker mode at the time the Working Group was established and as industry wide consultation was to take place with interested stakeholders, the Working Group was limited to members of Treasury, the ATO, the Board and its Secretariat.

1.3 OVERVIEW OF THE AT1 HYBRID MISMATCH ISSUE

1.3.1 An issuance of regulatory capital by an Australian regulated entity will generally not give rise to a hybrid mismatch outcome. However, a hybrid mismatch outcome can arise for cross-border regulatory capital instruments due to differences in the tax classification of those instruments across jurisdictions.

1.3.2 In an Australian context, the Action 2 Report impacts AT1 issued by some Australian banks and insurers out of a foreign branch (most commonly NZ or the UK) to Australian investors. Due to particular terms required to be included in AT1 issuances for regulatory purposes, AT1 issued by Australian regulated entities is classified as equity for Australian tax purposes. As such, returns paid on the AT1 to the investors are frankable (and typically required to be fully franked by the issuer in accordance with the benchmark imputation rules). Under the terms of issuance, to the extent the return is not franked, typically the investor will receive an increased cash return as a result of the gross-up formula embedded in the instrument. In a number of foreign jurisdictions, AT1 is treated as debt for tax purposes (in line with the accounting and legal form) and a deduction is available for returns paid on AT1 to investors (although some have restrictions on issuances out of foreign branches).[9]

1.3.3 Accordingly, where an Australian bank or insurer issues AT1 out of a foreign branch in a jurisdiction that allows a tax deduction for AT1 returns, whilst the return is likely to be assessable[10] to the Australian investor, the investor may receive a form of tax relief by way of a franking credit.

1.3.4 The Board understands that, as at the 30 June 2016 reporting period, there was approximately $7.3 billion of frankable AT1 recognised in regulatory capital issued from offshore branches (the UK and New Zealand) for which a foreign deduction has been claimed (out of total AT1 issued by Australian regulated entities recognised in regulatory capital of approximately $35.7 billion (please see Table 1)).[11] The Board also understands that, as the end of the 30 June 2016 reporting period, there was approximately $5.3 billion of AT1 recognised in regulatory capital issued under Section 215-10 which was still on issue. This includes legacy issues totalling

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9 Jurisdictions which allow a deduction for returns paid on AT1 include, amongst others, New Zealand, the UK and, in some instances, Singapore, Ireland, Hong Kong, France, Germany, Belgium, Spain, Italy and Portugal.

10 The assessable amount being the cash return plus a gross up amount for the imputation credit.

11 APRA's '*Quarterly Authorised Deposit-taking Institution Performance*', '*Quarterly General Insurance Performance*', and '*Quarterly Life Insurance Performance*' publications for the June 2016 quarter. The total amount issued reflects the amount of Level 2 regulatory capital of ADIs and Level 1 regulatory capital of insurers on issue as at 30 June 2016. The total AT1 of $35.7 billion shown above reflects AT1 on issue, which is different to the total amount of AT1 available to absorb losses ($34.5 billion) shown in Table 1. The $35.7 billion total AT1 on issue amount also includes approximately $1.2 billion of AT1 which is not available to absorb losses; for example, where one regulated entity holds an AT1 instrument issued by another regulated entity.

approximately $3.6 billion that were issued before the ATO took a more strict interpretation of section 215-10 in its draft ruling released in 2009.[12]

1.3.5 The Action 2 Report recommends that jurisdictions revisit their domestic laws where they currently provide dividend exemption or equivalent relief (including franking credit shelter) on deductible instruments to ensure they are achieving their stated policy objectives. On the basis that the stated policy objective of the imputation system in Australia is to relieve against double taxation of company profits,[13] this objective is not evident where the frankable return is in fact eligible for a deduction in a foreign jurisdiction.[14]

1.3.6 The Action 2 Report indicates that countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise from intra-group hybrid regulatory capital. This option was provided to address concerns that some regulators, such as the United States (US), require or encourage regulated entities to issue regulatory capital externally at the top holding company level and then downstream funding to subsidiaries. Absent an exception, intra-group regulatory capital legitimately issued as a result of these requirements could be caught within the hybrid mismatch rules.[15] The Action 2 Report did not provide a general exemption for regulatory capital, although in practice Australia is likely to be one of the few countries where regulatory capital issued to unrelated parties can be caught under the hybrid mismatch rules because Australia is one of the few countries to treat AT1 as equity for tax purposes, rather than debt.[16]

1.3.7 The Action 2 Report can potentially impact regulatory capital instruments in one of three ways:

(a) if Australia adopts OECD recommendation 2.1 (as recommended by the Board in its Hybrid Mismatch Report) in relation to regulatory capital instruments, the hybrid mismatch rules may operate to deny a franking credit to Australian investors where a financial instrument otherwise gives rise to a deductible/ no inclusion outcome (D/NI outcome). OECD recommendation 2.1 is an optional recommendation for jurisdictions to consider placing domestic law restrictions on access to any dividend exemption or other types of dividend relief to prevent a D/NI outcome arising under a financial instrument. Recommendation 2.1 has no scope limitations;

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12 Instruments issued between 1999 and prior to the time that the ATO released their draft version of TD 2012/19W (please refer to paragraph 2.4.27 of this Report for further details).

13 Explanatory Memorandum, *New Business Tax System (Imputation) Bill* 2002 (Cth), 1.8.

14 See example 2.1 of the Action 2 Report.

15 AT1 is treated as debt in the UK but equity in the US. Concerns had been raised that UK subsidiaries of US banks could be disadvantaged compared to local UK banks or subsidiaries of banks in other jurisdictions, who could raise deductible AT1 without the hybrid mismatch rules switching off the deduction.

16 Although New Zealand also has an imputation system, AT1 is treated as debt in New Zealand and accordingly cannot attach an imputation credit.

(b) if Australia does not adopt OECD recommendation 2.1 in relation to regulatory capital instruments, the payer jurisdiction can apply the primary rule in OECD recommendation 1 to deny a deduction for the AT1 return where a financial instrument otherwise gives rise to a D/NI outcome (where they have implemented OECD compliant hybrid mismatch rules). The scope of OECD recommendation 1 is limited to financial instruments that are structured arrangements or that are issued between related parties; or

(c) if (a) and (b) did not apply, Australia can apply the defensive rule in OECD recommendation 1 to deny the franking credit to the Australian investor where a financial instrument otherwise gives rise to a D/NI outcome.

1.3.8 The UK legislation[17] provides a full exclusion, at least for now, from the hybrid mismatch rules for regulatory capital instruments issued by banks and insurers. The Board understands that the UK Government will continue to review the regulatory capital position with any changes enacted through regulation at a later date.[18] It should be noted that unlike Australia, regulatory capital issued by UK banks to unrelated parties was not expected to be caught under the UK's hybrid mismatch rules, and as such the UK was mainly concerned with intra-group regulatory capital.

1.3.9 On 6 September 2016, the New Zealand Government released a discussion document proposing that New Zealand adopt the OECD recommendations on hybrid mismatch arrangements, and asking for submissions (due 11 November 2016). Paragraph 5.60 of the discussion document notes that New Zealand is not proposing to exclude bank regulatory capital from the hybrid mismatch rules in New Zealand. However submissions were sought on this point.

1.3.10 The implementation of hybrid mismatch rules in respect of 'third party' regulatory capital instruments raises additional complexities. This is because there is a regulatory requirement to raise regulatory capital with mandated terms which forms part of the settings for financial system stability and accordingly it is important that any additional tax settings should not:

- disturb these financial system stability objectives;
- result in tax outcomes, rather than business and regulatory requirements, driving AT1 issuance behaviour;

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17 The UK's '*Hybrid and Other Mismatches*' law is to take effect from 1 January 2017.

18 See paragraph 10.14 of HMRC's 'Tackling aggressive tax planning: implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements — Summary of Responses', December 2015.

- create execution uncertainty for capital raisings (for example where this creates additional or unnecessary uncertainty about tax consequences for investors); nor
- distort, bifurcate or create ‘crowding out’ conditions in the markets in which such capital is typically raised.

CHAPTER 2: BACKGROUND

2.1. OVERVIEW OF AUSTRALIAN REGULATORY FRAMEWORK

The Australian Prudential Regulation Authority

2.1.1. APRA is the prudential regulator of the Australian financial services industry.

2.1.2. APRA establishes and enforces prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions under its supervision are met within a stable, efficient and competitive financial system.

2.1.3. APRA supervises Australia's authorised deposit-taking institutions (ADIs — banks, building societies and credit unions), life and general insurance and reinsurance companies, friendly societies and superannuation funds (excluding self-managed funds).

2.1.4. APRA requires regulated entities to raise minimum levels of capital (under their respective prudential framework) and specifies mandated terms for various tiers of capital. These are mandated contractual terms, rather than statutory requirements. These terms are outlined and described further below.

The amount of regulatory capital on issue as at 30 June 2016[19] is shown in Table 1 below.

19 APRA's '*Quarterly Authorised Deposit-taking Institution Performance*', '*Quarterly General Insurance Performance*', and '*Quarterly Life Insurance Performance*' publications for the June 2016 quarter. The total amount issued reflects the amount of Level 2 regulatory capital of ADIs and Level 1 regulatory capital of insurers on issue as at 30 June 2016. The total AT1 of $35.7 billion outlined above at paragraph 1.34 reflects AT1 on issue, which is different to the total amount of AT1 available to absorb losses ($34.5 billion) shown in Table 1. The $35.7 billion total AT1 on issue amount also includes approximately $1.2 billion of AT1 which is not available to absorb losses; for example, where one regulated entity holds an AT1 instrument issued by another regulated entity.

Table 1: Regulatory Capital on issue

	Total $ (billion)	Major Banks[20] $ (billion)	Other ADIs[19] $ (billion)	General Insurers[21] $ (billion)	Life Insurers[22] $ (billion)
Common Equity Tier 1	222.9	151.0	37.8	22.0	12.2
Additional Tier 1	34.5	29.7	2.9	0.7	1.2
Tier 2	40.1	31.8	6.0	1.4	0.9
Total Capital Base	**297.5**	**212.5**	**46.7**	**24.1**	**14.3**

Authorised deposit-taking institutions

2.1.5. The prudential framework applicable to ADIs is set out in prudential standards made by the APRA under the *Banking Act 1959*. A core component of this prudential framework is the capital adequacy requirements applicable to ADIs, which aim to ensure that ADIs maintain adequate capital, on both an individual and group basis, to act as a buffer against the risks associated with their activities.

2.1.6. APRA's ADI prudential standards largely follow the framework set for internationally active banks by the Basel Committee on Banking Supervision and are applied in a way which is appropriate for Australia's financial system.

2.1.7. In December 2010, the Basel Committee published a new set of reforms designed to raise the level and quality of regulatory capital in the global banking system (the Basel III capital reforms).[23] The Basel III capital reforms represent the response to deficiencies in the international regulatory capital framework identified during the global financial crisis. The new standards came into force on 1 January 2013.[24]

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20 APRA's *'Quarterly Authorised Deposit-taking Institution Performance'* publication for the June 2016 quarter.
21 APRA's *'Quarterly General Insurance Performance'* publication for the June 2016 quarter.
22 APRA's *'Quarterly Life Insurance Performance'* publication for the June 2016 quarter.
23 See Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems – revised version June 2011* (Basel III Framework), accessible at **www.bis.org/publ/bcbs189.htm**.
24 The final prudential standards are accessible at: **www.apra.gov.au**.

General Insurers and Life Insurers (insurers)

2.1.8. The prudential framework applicable to insurers is set out in prudential standards made by APRA under the *Insurance Act 1973* and the *Life Insurance Act 1995*. In May 2010, APRA commenced a review of capital requirements for insurers. The purpose of the review was to improve the risk-sensitivity and appropriateness of these capital standards and, where appropriate, improve the alignment of capital requirements across the ADI and insurance industries. APRA's revised capital framework for insurers also took effect on 1 January 2013.[25]

Additional related party regulatory requirements

2.1.9. APRA has set limits on the financial exposure that Australian parent regulated entities may have to their subsidiaries and related entities. This can operate to restrict the amount that an Australian parent ADI or its branches may lend to regulated and non-regulated subsidiaries and other related entities. These restrictions do not apply to loans from the foreign branch back to the Australian parent.

Related party limits

2.1.10. APRA requires all regulated entities to limit their non-equity exposure to related regulated entities to below various limits. For related ADIs, the exposure is limited to a percentage of Level 1 Tier 1 Capital — being 50 per cent for any individual ADI and 150 per cent aggregate exposure to all related ADIs. The limits are significantly tighter for related non-ADIs.[26]

New Zealand subsidiaries

2.1.11. Around November 2015, APRA informed each of the four major banks that they would be required to reduce non-equity exposure to New Zealand subsidiaries even further than the prudential limits for exposures to related parties, to below five per cent of Level 1 Tier 1 Capital over a five year period commencing on 1 January 2016.[27]

2.2. Characteristics of Prudential Capital

2.2.1. The Basel III and revised insurance frameworks introduced new categories of regulatory capital and provided minimum requirements for their categorisation as regulatory capital. A key feature of Basel III is that in specified circumstances, certain capital instruments (AT1 and Tier 2) will immediately and irrevocably convert to ordinary shares (or mutual equity interests) or be written-off (the loss absorption and non-viability requirements).[28]

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25 The final prudential standards are available at: **http://www.apra.gov.au**.
26 Refer APRA Prudential Standard, *Associations with Related Entities,* APS222.
27 Refer the Disclosure Statements of each of ANZ, CBA, NAB and Westpac.
28 APRA Prudential Standard, APS 111 Attachment J, clause 1, April 2014.

2.2.2. Some key features of the different forms of regulatory capital are noted below.

- Common Equity Tier 1 (CET1) comprises the highest quality components of capital that fully satisfy all of the following prudentially mandated characteristics:
  - provide a permanent and unrestricted commitment of funds;
  - are freely available to absorb losses;
  - do not impose any unavoidable servicing charge against earnings; and
  - rank behind the claims of depositors and other creditors in the event of winding-up of the issuer.
- AT1 comprises high quality components of capital that satisfy the following prudentially mandated characteristics:
  - provide a permanent and unrestricted commitment of funds;
  - are freely available to absorb losses (see below for further detail);
  - rank behind the claims of depositors and other more senior creditors in the event of winding up of the issuer; and
  - provide for fully discretionary capital distributions.
- Tier 2 capital includes other components of capital that, to varying degrees, fall short of the quality of Tier 1 capital but nonetheless contribute to the overall strength of an ADI and its capacity to absorb losses.

Application of loss absorbency requirements to ADIs

2.2.3. The key requirements for a capital instrument issued by an ADI to be recognised as a component of regulatory capital that came into effect on 1 January 2013 are summarised in the table below.

Table 2: Key terms required for instruments to constitute regulatory capital

AT1	AT1 classified as a liability under Australian Accounting Standards must include a contractual provision whereby it will be immediately and irrevocably: a) converted[29] into ordinary shares or mutual equity interests of the ADI or its parent entity, which must be listed at the time the instrument is issued; or b) written off,[30] where the ADI's Level 1 or Level 2[31] CET1 capital ratio falls to or below 5.125 per cent of total risk-weighted assets.
AT1 capital and Tier 2 capital	An AT1 capital instrument or Tier 2 capital instrument must include a contractual provision whereby, on the occurrence of a non-viability trigger event, it will be immediately and irrevocably: a) converted into ordinary shares or mutual equity interests of the ADI or its parent entity, which must be listed at the time the instrument is issued; or b) written off. A non-viability trigger event is the earlier of: a) the issuance of a notice in writing by APRA to the ADI that conversion or write-off of capital instruments is necessary because, without it, APRA considers the ADI would become non-viable; or b) a determination by APRA, notified to the ADI in writing, that without a public sector injection of capital, or equivalent support, the ADI would become non-viable.

2.3. ACCOUNTING TREATMENT OF AT1

2.3.1. Historically, the accounting classification of Tier 1 hybrid instruments, as between equity and financial liability, has not always been consistent. This is as a result of divergent practice in the application of Accounting Standards, as well as the evolution of the terms of the hybrid instruments following changes to Basel requirements over time.

2.3.2. Pre-Basel III Tier 1 hybrid instruments were more commonly classified as equity for accounting purposes, depending on their terms. However, the mandatory features of Basel III AT1 have meant they are generally classified as financial liabilities for accounting purposes. This is reflected by the fact that recent AT1 issuances have been classified as financial liabilities.[32]

2.3.3. The distinction for accounting classification between a financial liability or equity relies on whether the issuer has the unconditional right to avoid delivering cash or another financial asset to the holder. If no unconditional right exists, the instrument is classified as a financial liability for accounting purposes.

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29 In the context of APRA's prudential standards, the term 'conversion' is used in a wide sense. Conversion includes exchange and also other transactions having the economic effect of conversion.

30 In the context of APRA's prudential standards, the term 'write-off' is intended to mean that the capital instrument is wholly extinguished.

31 In general terms, 'Level 1' comprises the ADI as an individual entity or the extended licensed entity, whereas 'Level 2' comprises the banking group of which the ADI is a member.

32 Based on the relevant regulatory disclosure statements of the major banks.

2.3.4. AT1 generally include terms which allow for the AT1 to convert into the issuer's ordinary shares under certain circumstances. For accounting purposes, the following features are also critical in distinguishing between their classification as equity or a financial liability:

- where the instrument will mandatorily convert into a fixed number of ordinary shares, the instrument is likely to be classified as equity, given that the price paid for the equity is effectively fixed at inception, and
- where the instrument will mandatorily convert into a variable number of ordinary shares, the instrument is more likely to be classified as a financial liability. This is because the issuer is still required to redeem the instrument for value, albeit in shares as opposed to cash.

2.3.5. For regulatory capital purposes, most (if not all) recent hybrid instruments also include non-viability and/or capital trigger clauses which provides APRA with the right to convert instruments if they deem that the issuer is no longer viable or has breached certain capital ratios. For accounting purposes, the occurrence of non-viability/capital trigger events are considered to be outside the control of the issuer and as such, conversion could potentially take place at any time. As such, the inclusion of these clauses alone, result in financial liability classification.

2.3.6. For completeness, it should be noted that the accounting classification would change to equity upon conversion to ordinary shares for AT1 initially classified as financial liabilities.

2.3.7. Whether an option to convert is at the holder's or the issuer's discretion can also impact the accounting classification, as can the currency in which the instrument is issued.

2.4. TAX TREATMENT OF HYBRID REGULATORY CAPITAL

Tax treatment before the debt and equity rules

2.4.1. A bright line debt and equity test was introduced into the *Income Tax Assessment Act 1997* in 2001 which resulted in tax equity treatment for Tier 1 hybrid capital instruments.[33] The Board understands that at that time, it was common for Tier 1 hybrid securities to be classified as equity for accounting purposes. As noted above, Basel III AT1 are classified as liabilities for accounting purposes due to the mandatory prudential features providing APRA the power to convert the instruments at their discretion.

33 Division 974 of the 1997 Act.

2.4.2. Prior to the introduction of this bright line test, the tax treatment of AT1 varied. In the 1980s, hybrid securities (instruments that contain both equity and debt features) were commonly issued by regulated and corporate entities as perpetual debt instruments with the payment of returns dependent on the profitability of the issuer. The returns on regulatory capital hybrids were deductible for tax purposes even though the instruments were recognised as regulatory capital for capital adequacy purposes and as equity for accounting purposes.[34]

2.4.3. The ATO initially focused on the application and use of the funds raised and concluded that, where the proceeds from the issue of the notes were to be used in the conduct of the issuing regulated entity's business, interest payable on the notes may be allowed as an income tax deduction.[35]

2.4.4. The ATO later changed its approach by focusing on the character of the advantage sought by the issuer in making the payments under the notes. They concluded that, as the main purpose of issuing the notes was to obtain a permanent and enduring advantage, the periodic payments were of a capital nature and not deductible.[36]

Overview of the debt and equity rules

2.4.5. The debt and equity rules in Division 974 use a bright line test to determine whether a financing instrument is to be treated as a debt interest or an equity interest for tax purposes. The test for this determination relies on the economic substance of the rights and obligations arising under the arrangement rather than merely on the legal form of the arrangement.[37]

2.4.6. Where an instrument is classified as a debt interest, distributions may be deductible, but are not frankable. Where an instrument is classified as an equity interest, distributions may be frankable, but are not deductible.

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34 Gordon Mackenzie, 'Taxation as a driver for designing hybrid securities' (2006) 1(1) *Journal of Applied Research in Accounting and Finance*, 31-42.

35 ATO, Income tax: convertible notes — meaning of convertible note — perpetual floating rate note, IT 2411, 18 June 1987 (withdrawn on 5 November 1999).

36 ATO, Income tax: deductibility of payments incurred on moneys raised through the issue of perpetual notes, TR 2002/15, 3 July 2002. The ruling does not apply to certain perpetual notes issued or allocated prior to 21 February 2001, being the date of issue of Draft Taxation Ruling TR 2001/D1.

37 Section 974-10 of the 1997 Act.

2.4.7. The distinction between debt and equity depends broadly on whether, in substance, an issuer has an 'effectively non-contingent obligation' to repay at least the amount of the investment.[38] If so, the instrument is considered economically more akin to debt and will constitute a 'debt interest' for tax purposes. To be a non-contingent obligation, the obligation must not depend on any event, condition or circumstance, including the economic performance of the issuer. If an interest satisfies both the debt test and equity test, it is treated as a debt interest (only) under the tiebreaker provisions.[39]

2.4.8. Further, regulations can be made to clarify what does/does not constitute a non-contingent obligation and an effectively non-contingent obligation for the purposes of the debt and equity rules.[40]

Tax treatment of Common Equity Tier 1

2.4.9. Ordinary share capital and the retained earnings of regulated entities represent the highest quality form of capital and qualify as CET1.[41] There is no effectively non-contingent obligation for issuers to repay shareholders an amount at least equal to their original investment. For this reason, ordinary shares are not debt interests for tax purposes. Ordinary shares represent an interest in the company as a member or stockholder and therefore constitute equity interests for tax purposes. Accordingly, any dividends paid are not deductible but may be franked.

Tax treatment of Additional Tier 1 capital

2.4.10. AT1 are generally issued as unsecured subordinated notes in Australia that are legal form debt rather than redeemable preference shares. One of the key features of AT1 is that the principal amount of the instrument is perpetual (that is, it has no maturity date) but may be converted to ordinary shares at the option of the issuer, subject to APRA approval.[42] AT1 may also convert earlier where either the capital trigger or one of the non-viability conditions is triggered.[43] AT1 may be redeemable after a five year period at the discretion of the issuer, if replaced by another capital instrument of the same or better quality and approved by APRA in writing (as noted below AT1 are typically redeemed at their first call date in practice) or if the issuer meets certain requirements relating to reductions in capital.[44]

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38 Section 974-135(1) of the 1997 Act Explanatory Memorandum, *New Business Tax System (Debt and Equity) Bill* 2001 (Cth), 1.9.

39 Section 974-5(4) of the 1997 Act.

40 Section 974-135(8) of the 1997 Act.

41 APRA Prudential Standard, *Capital Adequacy: Measurement of Capital*, APS 111, April 2014, cl 18.

42 Ibid, Attachment E, cl 8.

43 Under APS 111 (April 2014), Attachment J, the non-viability condition is triggered where the issuer's CET1 capital ratio falls below 5.125 per cent, or where APRA determines that the issuer would be non-viable without an exchange or a public sector injection of capital (or equivalent support).

44 APRA Prudential Standard, *Capital Adequacy: Measurement of Capital*, APS 111, April 2014, Attachment E.

2.4.11. The conversion clause gives the issuer (rather than the holder) a right to issue a variable number of ordinary shares or a mutual equity interest to the holder. This conversion feature characterises the instrument for tax purposes as an equity interest. The conversion clause combined with the discretionary nature of the payments serve to prevent the instrument being characterised as a debt interest for tax purposes because the provision of an equity interest upon conversion is not seen as the provision of a financial benefit,[45] and the discretionary payment does not constitute an effectively non-contingent obligation,[46] both of which are necessary conditions for satisfaction of the debt test.

2.4.12. Even absent these conditions, the characterisation of AT1 as a debt interest is less likely due to its perpetual term based on the present value calculation required under the debt test.[47] AT1 must provide for fully discretionary payments of interest.[48] While the interest is non-cumulative, the issuer may be restricted from paying dividends or returning capital on their ordinary shares until the next interest payment is made. The restriction on paying dividends on ordinary shares does not of itself create an effectively non-contingent obligation.[49]

2.4.13. On the basis of the above, AT1 satisfy the equity test, and do not satisfy the debt test. Accordingly, AT1 are characterised as an equity interest for tax purposes, with distributions on AT1 being frankable but not deductible.

2.4.14. Commercially however, these instruments operate like debt instruments, given that AT1 issuers make regular interest payments and generally redeem or roll over these instruments every five to seven years at the optional call date. Market expectations, however, cannot be taken into account for the purposes of assessing the debt or equity tax character of these instruments, as the test instead is determined by mandatory contingencies built into the terms of the instrument.

45 Subsection 974-30(1) of the 1997 Act.
46 Subsection 974-135(1) of the 1997 Act.
47 Section 974-50 of the 1997 Act.
48 APRA Prudential Standard, *Capital Adequacy: Measurement of Capital*, APS 111, April 2014, Attachment E.
49 Subsection 974-135(7) of the 1997 Act.

Tax treatment of Tier 2 capital

2.4.15. Tier 2 capital is comprised mainly of cumulative subordinated debt instruments that pay a fixed or floating rate of return. Tier 2 capital must have a minimum term of five years and may be redeemed before maturity at the issuer's discretion, subject to APRA's approval.[50] Tier 2 capital must also include a non-viability condition which imposes a contingency on the obligation to pay the principal and interest.[51] The non-viability condition would ordinarily have prevented certain Tier 2 capital from being treated as debt for tax purposes but for regulations that were introduced in 2012 to facilitate tax debt treatment.

Income tax regulations to facilitate tax debt treatment for Tier 2 capital

2.4.16. The treatment of regulatory capital for Australian tax purposes shows the difficulties in classifying instruments that effectively contain both equity and debt features. Regulations have been introduced at various stages to ensure that certain prudentially-mandated conditions (that may be necessary to promote financial system stability and avert bank failure) do not prevent the tax debt treatment of regulatory capital, if the instrument would otherwise be characterised as debt but for those conditions.

2.4.17. To remove the uncertainty in tax treatment, regulations were introduced in 2012 to facilitate the tax debt treatment of certain fixed term, cumulative, subordinated instruments issued by regulated entities by disregarding the non-viability condition for the purposes of the debt test.

2.4.18. Regulation 974-135F states that but for the non-viability condition, the terms of the note would ordinarily mean that payments of principal and interest are non-contingent obligations.

2.4.19. Prior to Basel III, a regulated entity's Tier 2 capital base was divided into Upper Tier 2 and Lower Tier 2.[52] Regulation 974-135D was introduced in 2010 to facilitate tax debt treatment of certain fixed term cumulative subordinated notes (Lower Tier 2) and regulation 974-135E was introduced in 2011 to facilitate tax debt treatment of certain perpetual cumulative subordinated notes (Upper Tier 2).

Australia's imputation (franking) system

2.4.20. Australia's imputation system alleviates double taxation of corporate profits (taxation at both the corporate entity and investor levels) by attaching franking credits to profits distributed to 'equity' investors.

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50 APRA Prudential Standard, *Capital Adequacy: Measurement of Capital*, APS 111, April 2014, Attachment H.

51 Ibid.

52 APRA Prudential Standard, *Capital Adequacy: Measurement of Capital*, APS 111, January 2012.

2.4.21. Generally all distributions on equity instruments (including equity instruments issued out of a foreign branch) must be franked to the same extent under the benchmark rules.[53] Penalties apply for a failure to frank according to the benchmark rules.

2.4.22. Broadly, franking credits received are included ('grossed-up') in the assessable income of an Australian resident investor, but are available to offset income tax that would otherwise be required to be paid by that taxpayer. A franked distribution to a non-resident investor is eligible for a specific exemption from withholding tax that may otherwise be levied.

2.4.23. Various integrity measures exist in the tax law to prevent companies directing franked distributions to some members only (streaming of franking credits).[54]

Exceptions to the requirement to frank — section 215-10

2.4.24. Section 215-10 provides an exception to the general rule that distributions on equity interests must be franked. It applies only to Australian resident ADIs issuing legal form debt that qualifies as Tier 1 capital and is treated as equity under Australia's tax debt/equity rules. The section 215-10 concession does not extend to all regulated entities, such as the insurers. The exception to the franking obligation arises, broadly, when the equity interests are issued at or through a foreign branch of an ADI in a listed country to raise funds for use in the foreign branch business.

2.4.25. The Explanatory Memorandum to the section 215-10 predecessor[55] indicates the provision was enacted to address a concern about competitive neutrality when ADIs seek the regulatory advantage of Tier 1 capital treatment by issuing securities through a foreign branch rather than a foreign subsidiary. The concern was that, by issuing through the foreign branch, the Australian resident ADI has an obligation to frank distributions (providing no benefit to foreign investors) which effectively increases the cost of raising capital — a cost that would not be borne by a foreign subsidiary or foreign independent entity raising funds and carrying on business in the same foreign jurisdiction.

2.4.26. The two main requirements under section 215-10 are that:

- the Tier 1 securities must be 'issued at or through a permanent establishment of the ADI in a listed country'; and

53 Section 203-25 of the 1997 Act.

54 These integrity measures include, among others, the benchmark rule (Division 203, 1997 Act), the anti-streaming rules (Division 204, 1997 Act), general anti-avoidance regimes applicable to franking credits (sections 177EA and 177EB, 1936 Act) and to dividend stripping (section 177E, 1936 Act), and holding period and related payment rules.

55 Section 160APAAAA of the 1936 Act.

- the funds from the issue of the securities are 'raised and applied solely' for the purposes of the ADI's foreign branch business which must not involve a transfer of funds directly or indirectly to Australia (the funds may also be used to re-finance branch business).

2.4.27. The ATO issued a draft ruling on the first requirement in 2009 that was published in final form in 2012. The ruling stated that, to satisfy the first requirement, the capital raising had to be a transaction of the business carried on at or through the foreign branch of the ADI and that it was not enough for the formalities of issue to take place there. The ruling was subsequently withdrawn by the ATO in 2014.

2.4.28. To date, no ruling has been published by the ATO in relation to the second requirement which involves the tracing of funds from a Tier 1 capital-raising to particular uses. The Board understands that the ATO is currently consulting on practical compliance issues associated with both of the section 215-10 requirements with a view to publishing guidance material in the near future. It is expected that the future guidance material will make it easier for ADIs to demonstrate that they meet the requirements of section 215-10, compared to more recent approaches taken by the ATO.

International Comparison — Taxation Treatment of AT1 Regulatory Capital Instruments

2.4.29. The Basel III capital reforms, which followed the global financial crisis, led to an increase in the volume and quality of core capital requirements for ADIs around the world. As discussed in paragraph 2.1.7 of this report, these reforms introduced a number of changes, including various mandatory equity-like features, which caused uncertainty in relation to the taxation treatment of such instruments around the world.

2.4.30. Given the uncertainty, a number of countries sought to clarify, via legislation or other means, the taxation treatment of AT1. Whilst many of these countries confirmed that AT1 should continue (or commence) to be classified as 'debt' for tax purposes and that a tax deduction should be available to the issuer, the tax treatment is not consistent globally. The tax treatment in some countries is premised upon legal 'form' concepts of debt. Others use a substance or accounting basis to characterise AT1 for tax purposes.

2.4.31. In this respect, distributions on AT1 are generally deductible for taxation purposes in Belgium, France, Germany,[56] Hong Kong, Italy, Japan,[57] New Zealand, Portugal, Singapore (albeit restrictions apply to Singaporean branches of foreign regulated entities), Spain,[58] Switzerland, the Netherlands and the UK (restrictions apply to UK branches of foreign regulated entities). Australia is one of only a few countries that treat ATI instruments as 'equity' for tax purposes and deny tax deductibility for the distributions made to investors (others include Canada, the US and Sweden).

2.4.32. In the last 12 months, Hong Kong and Ireland[59] have both enacted policy changes to the taxation treatment of AT1. Whilst both countries previously held the view that AT1 were generally 'equity' or 'quasi equity' in nature, the inclusion of specific provisions in their law means that future AT1 will be treated as 'debt' interests and that returns will be deductible for taxation purposes. Hong Kong considered that clarification of debt treatment by the Government would help enhance treasury operations within financial institutions and promote stability and resilience within the banking sector.[60] Based on public commentary, the policy change in Ireland was seen to bring Ireland in line with its European counterparts, and ensure that Irish financial institutions remain internationally competitive with respect to the cost of funding AT1.

2.4.33. In 2014, both Singapore and the Netherlands introduced laws to clarify that AT1 will be treated as debt for tax purposes, as the treatment under existing debt/equity tax tests following the Basel III reforms was uncertain.

2.4.34. The table below sets out a summary of the income tax treatment of AT1 in various jurisdictions to allow comparison.

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56 German tax law does not contain general rules for the treatment of AT1, rather relies on rules relating to profit participating interests.

57 In order to claim a tax deduction in Japan, the instrument must not be legal form shares (including preference shares).

58 Ibid.

59 Announced in Ireland's Finance Bill 2015 published on 22 October 2015. The Bill confirmed that instruments that qualified as AT1 will be treated as 'debt'. A withholding tax exemption applies if certain conditions are satisfied.

60 See Legislative Council Brief to the Inland Revenue (Amendment) (No 4) Bill 2015 issued by the Legislative Council of the Hong Kong Special Administrative Region of the People's Republic of China, pg 5, see **http://www.legco.gov.hk/yr15-16/english/bills/brief/b201512041_brf.pdf**.

Table 3: Comparison of tax treatment of AT1 in selected jurisdictions

United Kingdom	New Zealand	France
UK legislation specifically allows a tax deduction for AT1 (provided it is not a legal form share).[61] The tax characterisation of AT1 follows UK legal form of debt or equity. A UK PE of a foreign bank is assumed to have equity and loan capital as if it were a distinct and separate enterprise. This incorporates not just the arm's length amount of equity capital, but also the arm's length or separate enterprise mix of CET1 and AT1. WHT generally does not apply if the instrument is listed on a suitable exchange.	Distributions on AT1 are treated as interest and are deductible for taxation purposes. AT1 classified as debt for taxation purposes. If distributions are made to holders that are not associated, a bank levy of 2 per cent will apply to the distribution. If the holders are associated with the issuer, then interest WHT will be applied to the distribution.	French legislation allows deductible AT1 (where treated as debt for accounting purposes),[62] only if the lender is subject to tax on the distribution at a rate 25 per cent of the French corporate tax rate. In order to claim a tax deduction, the AT1 must not be legal form shares. Unlike the treatment in Australia, a conversion clause only results in equity characterisation from the date of conversion. No WHT applies if the AT1 is treated as debt for French GAAP purposes.
Singapore	**Hong Kong**	**United States**
Payable returns from AT1 other than shares, issued by Singapore incorporated banks (excluding their foreign branches) are treated as interest derived from a debt security and will be deductible for issuers.[63] This follows as a result of 2014 law changes to specifically allow for debt treatment. Prior to this, there was uncertainty as the tax characterisation starts with legal form, but then involves a substantive assessment where differences arise. A Singapore branch of a foreign bank needs to satisfy additional requirements for AT1 debt treatment, namely a subjective 'combination of factors' analysis.	Distributions on AT1 are treated as interest and deductible. As a result of legislation passed on 26 May 2016 — AT1 are now classified as debt for tax purposes. Prior to this legislative clarification, the tax treatment was dependent on the specific facts of each case, resulting in significant uncertainty (because the instruments contained features of both debt and equity).	AT1 must be issued as a preference share. Distributions on AT1 are non-deductible.[64] Instruments that qualify as Tier 1 capital under the Basel III standards will, generally, be characterised as equity for US tax purposes (due to the perpetual maturity date). An exemption from WHT does not apply to distributions made to non-resident holders. US corporations may be entitled to claim a 'dividends received deduction'.

61 UK Statutory Instrument 2013 No. 3209 and HMRC: *The Taxation of Regulatory Capital Securities 2013*.

62 The French tax treatment generally follows their French Generally Accepted Accounting Principles characterisation. AT1 can be classified as either a liability or as equity for accounting purposes, depending on their legal form and terms.

63 See section 10O, Part III of Income Tax Act (Chapter 134) revised edition 2014.

64 US federal tax law generally does not define an instrument for tax purposes as debt or equity, rather an instrument's classification is dependent on the particular facts and circumstances pertaining to that instrument.

Chapter 3: Terms of Reference — Key Factors

3.1 Key Issues arising from the Terms of Reference

3.1.1. The terms of reference are set out in Appendix A. The terms note that in determining how best to neutralise the hybrid mismatch arrangement involving regulatory capital, the Board should identify an implementation strategy that has regard to:

(a) delivering on the objectives of eliminating double non-taxation;

(b) capital regulatory requirements as enforced and set by Australian Prudential Regulation Authority;

(c) fostering a level playing field internationally and within the Australian banking and insurance sector;

(d) economic implications and potential market disruption;

(e) compliance and administrative costs for taxpayers; and

(f) interactions between Australia's existing domestic legislation, including with related tax laws.

3.1.2. Each of those factors has been considered below and in the Board's assessment of the various options available for consideration — refer Appendix D.

Delivering on the objectives of eliminating double non-taxation

3.1.3. This factor was the focus of the Board's review, and accordingly the Board put significant weight on this factor. All options considered by the Board may achieve this outcome. However, an exclusion for regulatory capital from the hybrid mismatch rules (under Option C, discussed at section 4.4), will only achieve this outcome where a foreign jurisdiction implements the Action 2 Report in relation to regulatory capital.

Regulatory capital requirements

Diversity of funding sources

3.1.4. The requirement to frank returns on AT1 has led to an observable bias towards issuances being made to the Australian retail market (predominately high net worth individuals, self-funded retirees and self-managed superannuation funds).

3.1.5. From a prudential perspective, it has been noted to the Board that concentration of a particular class of investors in a particular market can lead to greater financial system risk. A diversity of funding sources — including institutional placements both domestically and internationally — would spread the risk across investor classes in the event of financial market instability, including a banking crisis. It would also reduce the pressure for only one group of investors to bear significant losses in the event of financial system distress. In Italy, for example, the Government has faced political pressure to bail-out retail investors in regulatory capital instruments of Italian banks.[65]

3.1.6. By contrast, the market for Tier 2 instruments is more widely diversified relative to AT1, partially on the basis that distributions on Tier 2 are not required to be franked.

Resolution risk

3.1.7. The objective of regulatory capital requirements is that eligible capital is available to support the whole of the regulated entity.

3.1.8. The assets of a foreign branch of entities regulated by APRA are included in the prudential calculation of Australian regulated entities. A number of foreign jurisdictions have 'resolution' powers that give them the authority, when acting as the host authority, to act in the interest of the local jurisdiction, and such actions could include seizing foreign branch assets in a time of financial crisis. However, such actions are only likely to arise where a non-cooperative scenario arises between the home and host jurisdictions. This can result in those assets no longer being available to meet the obligations of the Australian parent regulated entity — even though they have been treated for prudential purposes as being available. This concern mainly impacts mobile activities that could be done in either jurisdiction.[66]

3.1.9. The US requires issuances of regulatory capital only from the US parent. Whilst this is not mandated in Australia, the Board understands that where the capital is raised may be a potential concern from an Australian financial system perspective where the place of issue results in assets being located in that jurisdiction. Tax settings which encourage issuances of AT1 out of a foreign branch are less favoured for this reason.

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65 The EU enacted new resolution requirements this year (the Bank Resolution and Recovery Directive), which require that private sector holders of certain liabilities bear a minimum amount of the costs of recapitalising failed banking institutions before governments can provide any capital support. This is designed to ensure that the costs of recapitalising failed banking institutions are primarily borne by creditors of that institution, not taxpayers. Up to half of the bail-in-able debt issued by Italian banks is owned by retail investors.

66 Generally, resolution powers will look to where the tangible assets are located, not where the funding is raised from. Therefore, if the Australian parent raises the funds and lends them to the foreign branch, the assets created in the foreign jurisdiction using those funds may be subject to seizure under the foreign regulator's resolution powers. However, where activities are mobile and could be undertaken in either jurisdiction, a policy which encourages AT1 to be raised onshore by the Australian parent may also encourage those mobile activities to take place in Australia (such that the resultant assets could instead be available to the Australian parent in a time of crisis).

Fostering a level playing field

3.1.10. Stakeholders submitted that the equity treatment of AT1 in Australia makes raising funds using these instruments uncompetitive internationally. The additional cost of raising capital overseas as a result of the requirement to frank is acknowledged in the Explanatory Memorandum to the predecessor provision to section 215-10.[67] International investors, who are not able to benefit from the use of franking credits, expect a gross-pay return (that is, there is an expectation that the quoted interest rate will be paid in cash and will not be reduced by 30 per cent to reflect the imputed value of the franking credit attached).

3.1.11. In addition, the Australian regional banks and smaller insurance entities without sizeable foreign branches submitted that the current tax settings do not provide a level playing field with major banks with foreign branches. The ability to issue 215-10 compliant deductible/non-frankable instruments allows the major banks to access a potentially cheaper source of funding than is available to the smaller banks. The ability to issue deductible/frankable instruments provides an additional benefit for some major banks but not regulated entities without foreign branches. The regional banks also noted competition concerns where the major banks can access international and institutional markets through unfrankable issuances (currently through their foreign branches), a concession that is not available to wholly domestic banks,[68] or insurers.

Economic implications and potential market disruption

Cost of funding

3.1.12. The concentration of investors in AT1 in the domestic retail market also has potential cost of funding implications.

3.1.13. There are capacity constraints in the Australian retail market, with particular pressure on pricing in years where multiple regulated entities seek to raise funding. These capacity constraints are only likely to increase if prudential regulators seek to increase the amount of regulatory capital regulated entities are required to hold.

3.1.14. Stakeholders have submitted that whilst the Australian retail market typically (and currently) provides the cheapest source of funding, there are times when cheaper or commercially more appropriate sources of capital exist outside this market (either from international investors or Australian institutional investors). In addition, greater liquidity in the market encourages cheaper pricing.

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67 Paragraphs 2.92 to 2.94 of the Explanatory Memorandum to *New Business Tax System (Debt and Equity) Bill 2001*.

68 However, the requirement in the section 215-10 concession to use the funds raised offshore means wholly domestic entities are arguably on a level playing field with the major banks for domestic activities.

3.1.15. Stakeholders have also noted that the additional prospectus requirements associated with retail issuances and additional prudential and tax sign off processes required for issuances out of a foreign branch means that Australian regulated entities are not able to quickly access alternative markets when pricing becomes favourable. It was submitted that regulated entities issuing Tier 2 are better able to take advantage of opportunities when pricing becomes lower in the offshore wholesale markets than the domestic markets. This is in part because prudential approvals can be sought in advance for an instrument and smaller tranches can be issued under the approved terms of that instrument as needed, without the need for the full prospectus processes required for retail issuances.

Risks for retail investors

3.1.16. A concern raised during consultations was that, potentially, not all investors in the Australian retail market may sufficiently understand or appropriately price the risk associated with AT1. Concerns have been raised (including by the Australian Securities and Investments Commission (ASIC)) about the concentration of risk being borne by Australian retail investors in the AT1 market, rather than 'sophisticated' investors in or outside Australia.[69]

3.1.17. In the United Kingdom, retail investors are precluded from investing in AT1 due to concerns that they lack the skills and resources necessary to evaluate and price the risks and potential benefits.[70] Instead, investments in AT1 are restricted to 'sophisticated' investors only, who are thought to better understand and price the level of risk associated with the investment.

Compliance and administrative costs for taxpayers

3.1.18. Some of the options considered by the Board give rise to greater compliance and administrative costs than others.

3.1.19. In particular, stakeholders noted compliance difficulties in satisfying the requirements of the existing section 215-10 and any option which is subject to a 'cap' mechanism, such as Option A2.

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69 *'Report 427. Investing in hybrid securities: Explanations based on behavioural economics, March 2015'*. Study commissioned by ASIC and produced by Queensland Behavioural Economics Group, and *'Report 365. Hybrid securities, August 2013'*, authored by ASIC.

70 *'Policy Statement PS15/14. Restrictions on the retail distribution of regulatory capital instruments, June 2015'*, Financial Conduct Authority.

3.1.20. This is in part because a capital raising needs to be of a sufficient size to be economical for the issuer. In addition, tax certainty for the life of the investment is an important consideration for investors. Potential difficulties were also noted with linking unfrankability with a foreign deduction (which ultimately cannot be determined with certainty at the time of issuance) or with a requirement that issuance is from a foreign branch, where the place of execution cannot be used to determine this. However, compliance and administration outcomes may ultimately depend on the design of the law.

Interaction with Australia's existing domestic legislation

3.1.21. This is considered in further detail in Chapter 5.

CHAPTER 4: OPTIONS FOR NEUTRALISING HYBRID MISMATCH

4.1 OVERVIEW

4.1.1. The Board examined a number of options to neutralise regulatory capital hybrid mismatch arrangements, having regard to the terms of reference for this project. These included:

- **Option A** — to make returns on AT1 unfrankable where returns on the instrument are deductible or the AT1 are issued in a foreign jurisdiction;
- **Option B** — to make returns on AT1 deductible; and
- **Option C** — to carve regulatory capital out of the hybrid mismatch rules.

4.1.2. The Board's terms of reference required the Board to consider factors beyond taxation policy settings. There is a complex interaction between existing and future taxation and regulatory policy settings for hybrid regulatory capital. The Board considered each of the above options against the terms of reference (refer Appendix C) outlined in detail in Section 3.1 and Appendix A. In addition to the terms of reference, the Board considered potential market responses which may arise from implementing each of the above options (and which may have flow on revenue implications). The Board is cognisant that some of the options may result in a cost to revenue relative to other options. However, this 'cost' may be acceptable where the benefits to the Australian economy or contribution to the stability of the financial system outweigh those costs. The Board notes this is ultimately a decision for Government.

4.2 OPTION A: CERTAIN DISTRIBUTIONS ARE UNFRANKABLE

Overview

4.2.1. The Board has considered a number of options which seek to make returns on AT1 unfrankable where an instrument is issued in, or returns are deductible in, a foreign jurisdiction, or in certain other circumstances (the 'A' options).

4.2.2. The Board has included detailed comments on each of the 'A' options considered in Appendix B and reviewed each against the terms of reference in Appendix C.

Streaming

4.2.3. As noted above, application of recommendation 2.1 in the OECD's Action 2 Report to deductible/frankable structures issued by foreign branches of Australian regulated entities would result in Australia treating any returns on AT1 issued out of a foreign branch as unfrankable, where the return is reasonably expected to be deductible in that jurisdiction (Option A1).

4.2.4. Whilst this would neutralise the hybrid mismatch, it would also have the effect of allowing Australian regulated entities to effectively stream franking credits to preferred investors. That is, regulated entities with foreign branches could choose whether to issue frankable AT1 to Australian residents out of Australia or unfrankable AT1 to non-residents out of the foreign branch, thus being able to allocate franking credits to taxpayers who can best use them.

4.2.5. As noted above in paragraph 2.4.24, a limited amount of streaming of franking credits to tax preferred investors by Australian ADIs is currently allowed for AT1 issuances by virtue of the concession in section 215-10.

4.2.6. The Board considered whether additional restrictions are required to prevent streaming of franking credits where one of the 'A' Options is adopted (these considerations are discussed in Appendix B). In weighing up the considerations, the Board does not consider streaming to be a significant risk due to the natural caps that exist from commercial practice and regulatory restrictions. In addition, the Board considers that streaming concerns should not outweigh the benefits of encouraging diversity of funding sources.

Options which do not limit streaming

4.2.7. The Board notes below a number of options which neutralise the hybrid mismatch but without limiting streaming:

- Option A1 - the application of recommendation 2.1 to deductible/frankable instruments issued by foreign branches of Australian regulated entities — this would result in Australia treating any returns on AT1 issued out of a foreign branch as unfrankable, where the return is deductible in that foreign jurisdiction; or

- Option A4 - returns on AT1 issued out of a foreign branch are unfrankable, where a deduction has been claimed in the foreign jurisdiction or the instrument is issued from a foreign jurisdiction. That is Option A1 is broadened to switch off franking for all overseas issuances of AT1.

Options which limit streaming

4.2.8. Should the Government wish to maintain existing policy settings and limit streaming of franking credits (in addition to the existing ability to apply Australia's various anti-streaming provisions), the Board also looked at two potential options which provide additional restrictions:

- replace section 215-10 with a cap on the amount of AT1 that can be issued as unfranked (Option A2); and
- retain section 215-10 restrictions to limit the ability to stream franking credits (Option A3).

4.2.9. Options A2 and A3 are discussed in detail in Appendix B.

Option A1: Unfrankable where deductible in another jurisdiction

4.2.10. This option neutralises cross-border hybrid mismatches, but with no other changes to the Australian tax law (other than to repeal or otherwise render section 215-10 redundant).

4.2.11. During the consultation process, potential difficulties were noted with linking the tax treatment of AT1 in Australia with a deduction in an offshore jurisdiction. For issuances out of the UK branch, the deduction available for AT1 is limited to the equivalent amount a UK subsidiary would have been able to claim had it issued the minimum AT1 required under the UK prudential standards (so as to put UK bank branches on a level playing field with UK banking subsidiaries). As a result, the deduction available for the UK branch may fluctuate year to year depending on the size of the risk-weighted assets held by the UK branch and is only confirmed after year end when a tax filing is made. For issuances out of New Zealand, typically a tax ruling would be obtained prior to issue, to confirm availability of a deduction for returns.

4.2.12. The Board observes that if this option were pursued, it would be desirable to limit execution risk and provide certainty and simplicity for investors by defining or deeming when the return on AT1 is taken to be deductible in another jurisdiction. This could include (for example) that the return is unfrankable where a deduction would generally be available in the foreign jurisdiction based on the terms of an equivalent instrument at the time of issue.

4.2.13. If there was a direct link to the actual deduction, disallowances of deductions under the foreign jurisdiction's thin capitalisation or transfer pricing rules could result in the frankability of AT1 issuances fluctuating year to year. This could lead to considerable tax uncertainty for both investors and regulated entities. The legislative drafting would also need to be flexible enough to deal with the UK branch example above, where a partial disallowance may arise.

4.2.14. However, the Board is aware that where a simplified compliance approach is taken by linking to the expected tax treatment in the jurisdiction the AT1 is issued from (at the time of issue), integrity concerns could arise as regulated entities could accidently or purposefully achieve an indirect hybrid mismatch outcome, by claiming a deduction in a jurisdiction that differs from the place of issuance. For example, this could occur where the funds were used in a NZ branch and notionally attributed to the NZ branch, notwithstanding that the AT1 have been issued from a non-deductible jurisdiction (such as a US branch). This could give rise to a frankable/deductible outcome, despite the application of Option A1. Requiring specific tracing of the funds would give rise to complexities as it may be difficult to trace whether the funds were sourced from the US branch's AT1 or from other sources (such as Tier 2 capital, debt funding or profits).

4.2.15. Stakeholders indicated in consultation that under this option, they will likely issue unfrankable AT1 out of their foreign branches to foreign residents or Australian institutional investors, but issue frankable issuances out of the Australian parent to Australian retail investors. Regional banks indicated this does not provide them with a level playing field, particularly where there is no restriction on the use of funds (unlike section 215-10), given they would not have the ability to access these markets under Option A1.

4.2.16. Regional banks were also concerned that Option A1 may encourage major banks to reduce their usage of the Australian franked market and seek to issue more AT1 using foreign branches. They were concerned that such an outcome would reduce the volume of AT1 issuances in the Australian capital markets and lead to less interest in the market from investors, analysts, broker sales teams, financial advisors and other participants. Such an outcome may make it more difficult for smaller institutions to issue into the market, given they rely more heavily on such participants to promote their issuances to investors, increasing their costs of issuing AT1.

4.2.17. Compared to Option A3, this option has the advantage of encouraging a greater diversification of funding sources and greater access to international markets, by removing streaming restrictions imposed by section 215-10. However, it has the disadvantage of not fostering a level playing field domestically and encouraging increased issuances through foreign branches, which could give rise to increased resolution risk[71] in the event of a banking collapse.

Option A4: Unfrankable where issued out of a foreign branch

4.2.18. Under this option, returns on AT1 are unfrankable where deductible or the AT1 is issued out of a foreign branch (regardless of section 215-10 or whether a deduction has been claimed in the foreign jurisdiction).

71 The ability for a foreign prudential regulator to seize the assets of the offshore branch (see paragraph 3.1.8).

4.2.19. This option would operate as an extension to the broader hybrid mismatch rule in Option A1 to neutralise deductible/frankable hybrid mismatches. Like Option A1, there is no restriction on the use of funds raised offshore – these may be lent back to the Australian regulated entity.

4.2.20. As evidenced by the practical difficulties that have arisen for section 215-10, difficulties can arise with determining the 'place of issue' for an instrument. This is discussed further in Appendix B. The Board does acknowledge that some of this uncertainty could also be removed by a codification setting out the requirements to evidence the place of issue.

4.2.21. Some stakeholders queried whether there was any clear policy rationale for allowing unfrankable issuances (without the restrictions of section 215-10) from jurisdictions that do not grant a deduction for AT1 returns.

4.2.22. Stakeholders submitted that Option A4 could achieve all of the positive outcomes of Option A1 (subject to the interpretation of 'issued out of a foreign branch' being clarified) but without the uncertainty of linking the Australian tax treatment with the foreign tax treatment. Option A4 was submitted to provide greater certainty than Option A1 and produce lower 'change of law' risk throughout the life of the instrument.

4.2.23. Concerns were raised during consultation that taxpayers could potentially still achieve a D/NI outcome if Option A4 was implemented, as most jurisdictions look to the use of the funds rather than the place of issue when determining whether a deduction is available. Accordingly, elements of Option A1 would be necessary to prevent a hybrid mismatch outcome if funds are raised in Australia but used in an offshore branch (no separate rule would be required, there simply would not be a carve out of regulatory capital from the general hybrid mismatch rules).

4.2.24. Option A4 requires a departure from existing policy settings, by permitting franking credit streaming. However, the Board considers that the commercial requirements of regulated entities will provide a natural limit on the amount of AT1 that will be raised through the foreign branch in an unfrankable form. It should also be noted that Option A4 provides greater flexibility for fundraising for the major regulated entities with branch operations, but does not extend this opportunity to the regional banks or other regulated entities that do not have branch operations.

4.2.25. The Board considers that Option A4 delivers the following benefits:

- it has more similarities to the approach suggested by the OECD than the 'B' options, by treating AT1 returns as unfrankable where deductible, but does extend the scope of the OECD's recommended approach to include any issuances outside of Australia even where no deduction is available;
- it allows regulated entities with foreign branch operations to raise capital from a diversified investor base, thereby reducing financial system risk;

- it allows major banks and insurers with foreign branch operations to compete for funding in international markets, thereby facilitating access to funding in which ever market is cheapest;
- it allows for greater tax certainty at the time of capital raising, compared to Option A1, which requires linkage to a foreign deduction (and which can give rise to tracing issues that may mask an indirect hybrid mismatch); or Option A3, which risks penal franking account consequences where funds are inadvertently brought back to Australia and has similar tracing issues to Option A1;
- it is potentially easier from a compliance and administrative perspective than the other 'A' options (provided the legislation has a defined place of issue, such as treating the instrument as unfrankable where the place of execution is outside of Australia).

4.2.26. However, the Board notes that Option A4 does not satisfy some of the other factors in the terms of reference, as set out below, and has the following disadvantages:

- it does not provide a level playing field domestically, as it favours major banks and insurers with foreign branch operations over wholly domestic regional banks and insurers and provides an opportunity for them to stream franking credits and effectively claim a deduction in Australia where funds are lent back from the foreign branch to the Australian parent. In particular, wholly domestic regulated entities are:
  - not able to access a diversified investor base to lower their cost of capital by accessing capital in which ever market is cheapest at the time;
  - not able to access the same streaming and deduction benefits noted above;
  - subject to potential adverse accounting profit outcomes, as the misalignment of the accounting and tax treatment of AT1 in Australia could give rise to 'permanent difference' outcomes which can increase tax expense and reduce accounting after tax profits for regional banks and insurers. Major banks and insurers with offshore operations can choose to eliminate the accounting and tax mismatch by issuing AT1 through an offshore branch in a jurisdiction that treats AT1 as debt for tax purposes;[72]

- it encourages capital to be raised through offshore branches rather than at the Australian parent level, which may:
  - encourage Australian regulated entities to carry on business and make profits outside of Australia (which are then taxable in the foreign jurisdiction rather than Australia); and
  - present an increased resolution risk (ability of foreign regulators to seize offshore assets) in the event of a banking crisis; and
  - it is more complicated from a compliance and administration perspective than Option B1.

In addition, there are potential compliance difficulties arising from Option A4 with determining the 'place of issue' for an instrument, as evidenced by the practical difficulties that have arisen for section 215-10. The Board acknowledges this risk but considers it to be manageable during the drafting process by providing codification of requirements to evidence the place of issue.

4.2.27. The Board also considered a variation of Option A4, where regulated entities may simply choose to issue non-deductible/unfrankable instruments out of the Australian parent or from a foreign branch (including where no deduction is available). As noted for Option A4, regulated entities are commercially unlikely to choose to issue unfrankable instruments from a jurisdiction which does not allow a deduction for returns (including Australia). Therefore, in the Board's view, the only advantage of this variation is allowing greater flexibility for regulated entities to raise funds from international or institutional sources where a branch issuance is neither possible nor desirable. However, this would seem to be an unnecessary complication of the law given it would likely rarely ever be used in practice. Accordingly, the Board did not recommend this variation.

Additional integrity concerns

4.2.28. For Options A1 and A4, the Board also considered if integrity measures were required to prevent foreign branches lending back funds to their Australian parent entities, either directly or indirectly via an offshore subsidiary, thereby generating an interest deduction in Australia from funds sourced from AT1 issued out of the foreign branch. However, the Board notes that this outcome is possible under the current tax law, and there are commercial, tax[73] and regulatory limitations on such activities. This is discussed more fully in Appendix B.

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73 For example, the thin capitalisation provisions in Division 820, 1997 Act.

Board's consideration – 'A' options

4.2.29. Whilst reiterating the Board's preference for Option B1, in examining the merits and detriments of the various 'A' options above, the Board considers that none of the 'A' options represent a clear advantage over any of the other 'A' options.

4.2.30. On balance, the Board considers that Option A4 is preferred out of the unfrankable 'A' category of options, as it encourages greater diversification of funding sources, but without the uncertainty of linking the Australian tax treatment to a foreign tax treatment.

4.2.31. The Board notes that linking a requirement to frank or not frank a distribution with a tax outcome (deduction) in an overseas jurisdiction under some of the 'A' options have the potential to increase execution risk for capital raisings. This is because the deduction is only determined and certain at the time of tax filing and it is inherently difficult to frame a domestic tax rule that captures every permutation of overseas deduction scenarios.

4.2.32. The Board considered whether the franking requirement could be linked to a 'proxy' for an overseas deduction (for example, based on the terms of the instrument at the time of issue). There are likely to be integrity concerns associated with any proxy and where funds may be raised in a non-deductible jurisdiction, such as the US, but 'used' in a deductible jurisdiction, this can create and require complex tracing to eliminate any indirect hybrid mismatch – which is not commercially possible.

4.2.33. The Board acknowledges this increased risk and considers that it can best be managed by implementing a rule which requires that returns are not franked where they are either deductible or issued outside of Australia under Option A4 (which may be specified as execution outside Australia). This will need to be 'defined' or clarified through the drafting process.

4.2.34. In conclusion, in weighing up the advantages and disadvantages of each option, the Board prefers Option A4 out of the 'A' options. However, the Board also notes that if the Government did not wish to change existing tax policy settings other than to neutralise the hybrid mismatch, and did not at this time wish to address the broader financial system impediments noted in this report, then Option A3 would achieve this (the Board's observations on Option A3 are included at Appendix B).

4.3 Option B: Treating AT1 as debt for tax purposes

Overview

4.3.1. As noted above in paragraphs 2.4.10 to 2.4.14, there are a number of mandatory regulatory features of AT1 (prescribed by APRA), which result in equity classification for Australian tax purposes.

4.3.2. The Board considered whether Australia could neutralise hybrid mismatches by more closely aligning the tax treatment of AT1 with its other major trading partners, by allowing AT1 to be treated as debt for Australian tax purposes (Option B1). This would result in a departure from the current equity classification under Australia's debt/equity tax rules.

4.3.3. However, like some of the 'A' options above, the outcomes of this reclassification go beyond just the neutralisation of regulatory capital hybrid tax mismatches (which currently comprise around a fifth of all AT1 on issue). It has wider implications and involves a significant policy shift in the tax treatment of all AT1.

Option B1: Debt tax treatment for AT1

Terms of reference — application of factors

4.3.4. The Board reviewed the option to treat AT1 as debt against the factors set out in the terms of reference:

- Eliminate double non taxation
  - This is achieved by aligning the tax treatment with international outcomes.
- Regulatory capital requirements enforced by APRA
  - Diversity of funding sources — deductible AT1 would allow for gross-pay returns to investors, which would open up access to both Australian and international institutional investors. This is a positive outcome as it provides access to greater liquidity and de-concentration of risk.
  - Resolution risk — making AT1 returns deductible in Australia will encourage the raising of AT1 from the Australian parent rather than from a foreign branch (due to the fact that the Australian corporate tax rate is higher than overseas jurisdictions and that it is generally cheaper and more administratively simple to raise funds at the parent level). This may encourage mobile activities that could be done in either jurisdiction, to take place in Australia, thus lessening the risk of such assets being seized by a foreign regulator in a crisis situation. Conversely, to the extent that such activities take place offshore, a resolution risk would occur in relation to assets generated offshore.
- Fostering a level playing field
  - Deductible AT1 would allow for gross-pay returns to investors, thereby allowing Australian regulated entities to compete for funding from international markets, as well as facilitating widening the Australian domestic market from just the retail market to both the retail and wholesale markets;

  - Deductible AT1 would provide a level playing field between the major Australian banks, the Australian regional banks and insurance entities, as it removes the requirement to issue out of a foreign branch to obtain a tax deduction.

- Economic implications and potential market disruption
  - Increased liquidity — greater access to a more diverse investor base may reduce the capacity constraints in the domestic retail market (crowding out conditions), provide greater liquidity and allow a more effective and faster response to raise funds and access alternative markets (foreign and domestic wholesale investors) when pricing becomes favourable.
  - Risks for retail investors — whilst it is unlikely that deductible AT1 will result in a significant decrease in the retail hybrids market, it should mean a greater spreading of the risk to more sophisticated investors who are thought to better understand and price the level of risk.
  - In order to reduce market disruption, transitional issues will need to be managed appropriately. We have made observations regarding this issue at section 6.3 of this Report.

- Compliance and administrative costs for taxpayers
  - Debt treatment for AT1 is an administratively simpler option and should have a minimal compliance burden on taxpayers.

4.3.5. As demonstrated above, Option B1 satisfies all of the factors within the Board's terms of reference.

4.3.6. Appendix D includes a comprehensive comparison of Option B1 against the terms of reference.

Option B2: Optional debt or equity treatment of AT1

4.3.7. Some stakeholders suggested that issuers could be allowed to choose whether to treat their AT1 as debt or equity for tax purposes. The choice could effectively be determined depending on the type of instrument issued, as is the case in France and Singapore. For example, tax treatment could be determined by way of legal form (with share instruments[74] treated as equity and note instruments as debt) or by following the accounting classification, or by some other elective means.

74 The Board notes that section 254K of the *Corporations Act 2001* places restrictions on the redemption of redeemable preference shares — they must be redeemed out of profits or the proceeds of a fresh issue of shares made for the purposes of the redemption — which limits the commercial effectiveness of share instruments for AT1.

4.3.8. Stakeholders submitted that this would allow regulated entities the greatest flexibility in raising regulatory capital. That is, issuances to Australian retail investors could be issued as frankable non-deductible AT1, whereas issuances to foreign and domestic wholesale investors could be issued as unfrankable deductible AT1. This would allow regulated entities the choice to continue to issue franked distributions and credits to a retail market that has come to expect frankable hybrid instruments.

4.3.9. Whilst the Board considered this proposal had some merit, it was considered that such a choice of tax treatment for AT1 would add complexity to the tax system. Whilst retail investors are used to receiving franking credits from their hybrids investments, they will be no worse off receiving gross pay unfranked instruments. Other stakeholders indicated an expectation that the domestic retail market will adjust to the change.

4.3.10. The Board also considered that, in a post-BEPS world where one country's hybrid mismatch rules are dependent on the tax treatment of a financial instrument in another jurisdiction, having an optional tax treatment for AT1 could cause additional complications. It would also still require a rule like Option A1 or A4 to prevent hybrid mismatch outcomes.

4.3.11. The Board also looked at variations which may restrict the volume of AT1 that could qualify for debt treatment. These variations included a cap on the level of AT1 that could be issued as debt – for example, based on a fixed percentage of AT1, or based on the amount of foreign currency AT1 that could be issued (as stakeholders had indicated that foreign investors typically favour foreign currency denominated AT1 over AUD issuances). However, the Board notes that any sort of issuance or currency cap has the potential to add additional complexity to the law and would have limited policy justification (other than possibly constraining revenue implications).

Integrity concerns — excessive issuance of AT1

4.3.12. The Board considered whether debt treatment of AT1 could give rise to issuances in excess of regulatory requirements in order to obtain a deduction for AT1 returns.

4.3.13. Stakeholders noted that even if AT1 returns were deductible, it is still a more expensive form of funding than Tier 2 or non-regulatory sources of funding. This provides a natural cap on the amount of AT1 that a regulated entity would be willing to issue in preference to other debt instruments. That is, where a debt deduction can be obtained by issuing another instrument (Tier 2 or ordinary debt), then these are likely to be preferred. This is consistent with the debt treatment afforded to certain Tier 2 instruments; there have not been excessive issuances of Tier 2 observed since regulations were introduced to facilitate debt treatment.

4.3.14. In addition, Australian thin capitalisation restrictions provide a legislative constraint on the level of debt (including AT1 under Option B1) used to fund the Australian operations of regulated entities.

4.3.15. For these reasons, the Board agrees with stakeholders that the risk of excessive AT1 issuances due to tax debt treatment is low.

Board's consideration

4.3.16. There is a growing global trend towards countries facilitating debt treatment for AT1 issued by regulated entities. A number of Australia's key trading partners - notably, UK, Singapore, New Zealand and a number of EU countries - treat AT1 as debt for tax purposes. More recently, Ireland and Hong Kong have changed their tax laws to provide tax debt treatment for AT1 to allow their regulated entities to compete internationally for capital.

4.3.17. Debt treatment of AT1 in Australia would achieve all of the factors set out in the terms of reference. Gross pay returns can encourage diversity of funding including the foreign and domestic institutional market.

4.3.18. This has multiple benefits, including:

- diversifying financial system risk away from a particular segment of the market (which risks compounding the market consequences of a banking collapse where there is a concentration of domestic retail investors);
- freeing up capacity should there be an overcrowded domestic market, in which smaller regulated entities and corporate entities compete with major regulated entities for funding;
- shifting some of the investor base from a retail market, which may not fully understand or correctly price the risk of these instruments, to a more sophisticated wholesale market (noting that in the UK regulated entities are banned from issuing AT1 to retail investors due to this misconception of risk).
- debt treatment of AT1 also encourages the raising of regulatory capital at the Australian parent level, thereby enabling Australia to tax the profit margin on the transaction rather than the foreign jurisdiction (unless the capital raised at the Australian parent level is allocated by the Australian parent to a foreign branch).
- in addition, debt treatment of AT1 will provide a level playing field for all Australian regulated entities both domestically and internationally. Regional Australian banks will have the same tax treatment for AT1 as the major Australian banks.

4.3.19. The Board acknowledges that debt treatment of AT1 will be a departure from the bright line test in the debt/equity rules in Division 974. However, the regulation making power in the debt/equity rules contemplates and facilitates such a departure, and there is existing precedent in doing so with the regulations to facilitate debt treatment for certain Tier 2 instruments.

4.3.20. The Board acknowledges that there are potential flow-on tax revenue consequences from this measure where it results in increased participation by non-resident investors in AT1. However, this is also a consideration for Options A1 and A4, which also encourage diversification of funding sources.

4.4 Option C: Carve out for regulatory capital

Background

4.4.1. The Board also considered whether Australia should exclude regulatory capital from the hybrid mismatch rules, and instead rely on the foreign payer jurisdiction to apply Recommendation 1 of the OECD Action 2 Report to deny the tax deduction in their jurisdiction where a hybrid mismatch arises (Option C). This approach would be simple from an Australian perspective as it requires minimal change to Australian tax legislation.

4.4.2. However, this approach will only result in the neutralisation of a hybrid mismatch where the foreign jurisdiction has implemented hybrid mismatch rules. For example, the UK has chosen to carve out regulatory capital from their hybrid mismatch rules. If Australia were to provide a carve-out for regulatory capital, it could still be possible for deductible/frankable hybrid structures to be issued out of UK branches of Australian regulated entities.

4.4.3. Appendix D contains a comparison of Option C against the terms of reference.

Views in submissions

4.4.4. A number of stakeholders submitted that Australia should not apply the hybrid mismatch rules to regulatory capital. A summary of the key points made in submissions on the application of the hybrid mismatch rules to regulatory capital in response to the Board's November 2015 Consultation Paper are set out in the Board's Hybrid Mismatch Report. Broadly, submissions raised the following concerns:

- if the hybrid mismatch rules were to apply to hybrid regulatory capital instruments, the cost of capital for the Australian banking and insurance sector would increase.[75] This could have flow on implications to the extent these costs are passed onto consumers;
- some submissions queried whether franking credits should be considered 'equivalent tax relief' under OECD recommendation 2.1;

75 See IAG, ANZ and the joint submission by NAB, CBA, Westpac and Macquarie Bank. Estimated that the additional cost of new AT1 to replace deductible/frankable instruments could be 100-150 basis points higher, but may even exceed 200 basis points.

- there were a number of potential complexities in the interaction with the existing law, including the franking credit streaming rules and the ability to 'link' to a foreign deduction; and
- concerns were raised by the regional Australian banks that they are at a competitive disadvantage in accessing a cheaper cost of funding as they do not have significant offshore branches through which they can issue AT1.

Board's consideration

4.4.5. As noted in the Board's Hybrid Mismatch Report, indications from Treasury are that the increased costs of capital for regulated entities that are no longer able to issue deductible/frankable AT1 as a result of the hybrid mismatch rules is not likely to cause significant disruption to the market. In addition, even if these additional costs are passed on to customers, it is unlikely to have a material impact on pricing of loans to customers.

4.4.6. Even if Australia does provide a carve out, regulated entities may face a period of uncertainty while other jurisdictions determine their own response to the OECD's Action 2 report. As a result of this uncertainty, Australian regulated entities may cease issuing deductible/frankable AT1 from offshore branches altogether.

4.4.7. The Board considers that maintaining the status quo does not achieve many of the other factors in the Board's terms of reference. That is, it does not encourage a diversification of funding sources, issuance from the parent entity or deal with the issues of a domestic and international level playing field.

4.4.8. Further, the Board is cognisant that 'doing nothing' in relation to the implementation of the OECD hybrid mismatch rules for regulatory capital may be perceived as condoning deductible/frankable hybrid regulatory capital structures, as well as providing special treatment to regulated entities.

4.4.9. Australia has committed to implementing the hybrid mismatch rules and exceptions should only be granted where there is a compelling case to do so. The Board does not consider a sufficiently compelling case has been made to exclude regulatory capital from the application of the hybrid mismatch rules. The increased cost of capital to regulated entities as a proportion of their overall funding is not expected to be significant. Accordingly, the Board does not recommend Australia provide a carve out for regulatory capital (Option C).

4.5 OBSERVATIONS ON POTENTIAL BEHAVIOURAL IMPACT OF OPTIONS

4.5.1. The Board has made some general observations in respect of how the market may respond to the various policy options based on consultations. Importantly, the Board notes that:

- Unfranked gross returns are likely to have broader investment appeal both domestically and internationally and encourage participation by wholesale investors;
- Greater diversity and depth in the market may improve the financial stability for issuers and deconcentrate the risk of losses in a crisis scenario away from Australian retail investors to international and domestic wholesale investors;
- Conversely, existing domestic retail investors may face increased competition from international and wholesale investors for participation in AT1 issuances where they provide a gross cash return;
- Increased competition may result in a reduced cost of funding for the issuer but it is difficult to predict how this may ultimately affect borrowing costs, since this is a capital management question for the board of the regulated entity;
- A requirement to not frank AT1 issuances which are deductible in a foreign jurisdiction may encourage offshore 'branch' capital raisings; and
- Australian issuances of AT1 would likely be made in Australian dollars (AUD) whereas international issuances would likely be made in a currency other than AUD (typically USD or Euro).

Tax and net cash implications of a switch from equity to debt

4.5.2. The Board notes that under an imputation system, the effective rate of tax on the return on either a debt or equity instrument issued by a corporate taxpayer should be the same for any specific class of domestic investor. This arises broadly because there is a corporate deduction (at 30 per cent) for a debt interest and a franking credit (at 30 per cent) for an equity interest, as follows:

Table 4: Comparison of effective rate of tax on debt and equity instrument returns

	Individual (assuming a 49% rate of tax)	Company	Superannuation Fund	Non resident
Overall tax impact of a debt interest	49% assessable income (investor) — 30% deduction (issuer)	30% assessable income (investor) — 30% deduction (issuer)	15% assessable income (investor) — 30% deduction (issuer)	0% assessable income (investor) — 30% deduction (issuer)
Overall tax impact of an equity interest	49% assessable income (investor) — 30% franking credit (investor)	30% assessable income (investor) — 30% franking credit (investor)	15% assessable income (investor) — 30% franking credit (investor)	0% assessable income (investor) — 30% franking credit (bank distributes but investor can't use)

4.5.3. As can be seen from Table 4 above and Table 5 below, changing the tax treatment of AT1 from equity to debt (Option B) for a wholly domestic taxpayer within a particular tax rate class should be neutral at the investor level. Whilst debt treatment allows for the regulated entity to claim a deduction, the regulated entity must pay the domestic investor an increased cash return (which is generally at least equal to the equivalent tax saving from the debt deduction).[76] Accordingly the investor receives an increased return and pays an increased amount of tax (which excludes any franking credit).

4.5.4. However, this does not mean that regulated entities will benefit by this change at the expense of investors – as shown in Table 5 below. All other things being equal, the regulated entity will incur the same cash expenditure in paying the return to investors on AT1:

- Currently the regulated entity pays company tax at 30 per cent to generate an imputation credit which is distributed to the investor as part of the overall AT1 return (reducing the gross cash return received by investors);
- Under a deductible AT1 model, the regulated entity pays a gross cash return on an AT1 capital instrument which is deductible which should equate, all other things being equal, to the distribution received on franked instruments;
- That is, instead of paying company tax and distributing an imputation credit for this value, the return is paid in cash directly to the investor.

76 The formula for an unfranked distribution (represented by the 0% below) generally grosses up the amount as follows:

$$\frac{\text{Distribution}}{1 - (\text{Tax rate x } (1 - \text{Franking percentage } (0\% \text{ if unfranked})))}$$

4.5.5. Domestic investors should receive the same level of cash return under a deductible model compared to an imputation model – arguably sooner under the gross cash model (since they do not need to wait to receive a franking credit offset or refund as part of their annual tax filing).

4.5.6. While a domestic investor may be indifferent to a change from equity to debt the same cannot be said for a foreign investor. The position and comparison for a foreign investor is more nuanced. Where the AT1 is frankable, the interest yield (which is set according to the market at the time) will typically be provided to the investor as 70 per cent cash, with the remaining 30 per cent of value provided as a franking credit. However, as foreign investors are not able to use franking credits, to accept a franked return would mean accepting only 70 per cent of the market yield. Where AT1 is unfrankable (whether because it is treated as debt for tax or otherwise), the investors will receive the full yield (set by the market) in cash. For this reason, an unfrankable instrument is significantly more valued than a franked instrument by foreign investors.

Table 5: Comparison of Equity versus Debt Treatment

	Equity (Franked distribution issued from Australia)	**Debt (Deductible in Australia; non-frankable)**
Tax paid at investor level (domestic individual on the highest marginal tax rate)		
Assessable income — cash AT1 coupon received	$70	$100
Gross up assessable income — franking credit	$30	$0
Total assessable income	$100	$100
Tax payable (at highest marginal rate 49 per cent)	($49)	($49)
Allowable offset — franking credit	**$30**	**$0**
Total tax payable by investor	**($19)**	**($49)**
Net cash received by investor	**$51** ($70 cash coupon less $19 tax paid)	**$51** ($100 cash coupon less $49 tax paid)

Table 5: Comparison of Equity versus Debt Treatment (continued)

	Equity (Franked distribution issued from Australia)	Debt (Deductible in Australia; non-frankable)
Tax paid at corporate level		
Assessable income — ADI uses cash from AT1 to invest — assume $10 margin above funding cost	$110	$110
Allowable deduction — AT1 coupons	($0)	($100)
Taxable income	$110	$10
Australian tax payable by corporate at 30 per cent	**$33**	**$3**
Impact on franking account	+$3 ($30 credit paid to investor but $33 credit generated from tax payment)	+$3 (no credit paid but $3 credit generated from tax payment)
Net cash received by ADI	**$7** ($110 investment income less $70 cash coupon less $33 tax)	**$7** ($110 investment income less $100 cash coupon less $3 tax)
Total aggregate Australian tax paid by corporate and investors	**$52**	**$52**

4.5.7. Accordingly domestic investors should be 'indifferent' between receiving a franked AT1 return or a grossed up (unfranked) cash return.

Removing franking requirements results in a behavioural shift from wholly domestic investors to an increase in foreign investors

4.5.8. Allowing AT1 to be unfranked (Options A or B) is expected to facilitate a diversification of funding sources for regulated entities. For the 'A' options, diversification is only realised by those regulated entities which have branch operations. For Option B, there is no such limitation.

4.5.9. Commercially, a regulated entity could be expected to raise capital wherever it is cheapest. However, factors such as currency requirements and the tenor of funding needed are also be taken into account by regulated entities when deciding where and who to raise capital from. Stakeholders have noted that they still expect the majority of AT1 funding to come from domestic retail investors, as historically this has been the cheapest source of funding. However, they also expect an increase in participation by foreign and Australian institutional investors (such as large superannuation funds) where regulated entities are able to raise AT1 in an unfrankable form. Funds raised from foreign and institutional investors may be for a longer term (for example, 10 years) than funds raised from the domestic retail markets (typically 5 years). It would also be expected to be raised in a foreign currency (such as USD) where an issuance is predominately aimed at foreign investors.

4.5.10. Although franked AT1 is predominantly held by domestic investors, a limited proportion is currently held by foreign investors (mainly through section 215-10 unfrankable issuances). There may be a behavioural shift whereby there is an increase in foreign investors in response to the proposals. That is, foreign investors, who are not subject to Australian tax on AT1 returns received, may replace domestic investors. There may also be a shift in domestic investors from a higher rate taxpayer (such as a top marginal tax rate Australian resident taxpayer) to a lower rate taxpayer (such as a superannuation fund).

4.5.11. Likewise, some of the 'A' options (options A1 and A4) are also expected to result in a shift from a wholly domestic retail investor base to one that includes foreign residents and Australian institutional investors. Under these options there is no restriction on the use of funds raised at the branch level in unfrankable form.

4.5.12. The mix of investors and the likely source of funding is inherently difficult to predict and will be a capital management decision of the Board of the regulated entity based on all available information and conditions at the time of the capital raising.

4.5.13. However, the Board observes that typically increased foreign investment is viewed as economically positive for Australia.

Behavioural shift from raising AT1 at foreign branch to raising at Australian parent level

4.5.14. Making AT1 returns deductible in Australia under Option B will encourage the raising of AT1 from the Australian parent entity rather than from a foreign branch (due to the fact that the Australian corporate tax rate is higher and it is generally cheaper and more administratively simple to raise funds at the parent level).

4.5.15. Under the 'A' options, some regulated entities have the option of raising funds at the foreign branch level (as this is the only opportunity to issue unfrankable instruments). This is particularly the case for options A1 and A4, where there is no restriction on the use of funds; and to a lesser extent options A2 and A3, where the ability to raise funds offshore is possible but limited.

4.5.16. To the extent fundraising occurs at the Australian parent level, it is also likely to generate additional income for the regulated entity in Australia (as the funds raised in Australia would be invested, or lent to overseas operations), which should at least in part offset the deduction allowable to the regulated entity and may even give rise to additional profit margin to be taxed in Australia.

4.5.17. Hence, for business activity that could be undertaken in either jurisdiction, encouraging fundraising to take place at the Australian parent level allows Australia to tax the profit margin on that business.

Summary

4.5.18. In summarising its observations, the Board notes that:

- For domestic investors within the same class, a switch from equity to debt treatment should be neutral;
- The Board also notes that a behavioural shift toward issuances to foreign residents or lower tax rate institutional investors, could reasonably be expected to occur for all options that encourage diversification of investors, but particularly where there is no restriction on the use of funds raised (being Options A1, A4, and B1);
- Option B1 encourages fundraising at the Australian parent level. Where this occurs, it is also likely to generate additional income for the regulated entity in Australia (as the funds raised in Australia would be invested, or lent to overseas operations), which should at least offset the deduction allowable to the regulated entity (and may also generate an additional profit margin); and
- Option A3 and Option C have the least change to existing tax settings, and therefore could reasonably be expected to have the least behavioural change.

Board's Recommendation

4.5.19. Each of the options considered by the Board has potential to neutralise hybrid mismatch arrangements, consistent with Australia's commitment to implement the OECD BEPS recommendations. The terms of reference for the Board (as set out in Appendix A) are broader than international taxation considerations and require an examination of a number of regulatory, market, economic and competition factors.

4.5.20. The Board assessed each of the options against the terms of reference (refer Appendices A and D) and supports options which provide the greatest benefit from a whole of system perspective (consistent with the terms of reference). The Board also considered preference should be given to tax policies which least inhibit the way an entity carries on its business commercially.

4.5.21. The Board is cognisant that some of the options considered may have a cost to revenue relative to other options and to the existing law. As noted above, this will depend on the actual behavioural responses which are inherently difficult to predict and which are contingent on a variety of external market factors. Accordingly, the Board has noted some alternate approaches in this report should the Government consider the Board's preferred option is not possible at this time. However, the alternative approaches are unlikely to give rise to the same level of market and financial system benefits as option B1.

RECOMMENDATION

4.5.22. The Board notes that each of Options A and B will neutralise hybrid mismatch arrangements consistent with Australia's commitment to implement the OECD BEPS recommendations.

4.5.23. Out of the variations examined, the Board recommends Option B1, as it brings broader regulatory, market, economic and competition benefits, beyond just neutralising deductible/frankable hybrid mismatches (these benefits are detailed at paragraph 4.3.18).

4.5.24. Treating AT1 as debt for Australian tax purposes (Option B1) meets both tax and regulatory objectives. It is the only option which appears to meet all of the factors noted in the terms of reference — by diversifying the investor base, encouraging onshore fundraising, providing a level playing field internationally and domestically and being simple to comply with and administer. The Board notes that this option goes beyond neutralising hybrid mismatch arrangements (more so than the 'A' options) to change the tax treatment of all AT1, not just AT1 issued from an offshore branch. As a result, the option also provides broader benefits than the other options.

ALTERNATE RECOMMENDATION

4.5.25. As noted above, out of the variations examined, the option preferred by the Board is Option B1. In the event that an alternate recommendation to Option B1 was required however, the option next preferred by the Board is Option A4, for the reasons noted below.

4.5.26. Under Option A4, returns on AT1 are unfrankable where deductible or the AT1 is issued out of a foreign branch (regardless of section 215-10 or whether a deduction has been claimed in the foreign jurisdiction). There is no restriction on the use of funds raised offshore – these may be lent back to the Australian regulated entity. This option has the advantage of more closely aligning with the OECD's proposed hybrid mismatch rules than Option B1, whilst achieving a number of the factors noted in the terms of reference — by diversifying the investor base, providing a level playing field internationally and being simpler to comply with and administer than the other 'A' options.

4.5.27. However, Option A4 does not provide a level playing field domestically, as it favours major banks and insurers with foreign branch operations over wholly domestic regional banks and insurers. In addition, it encourages capital to be raised offshore rather than from Australia (which can increase resolution risk in the event of a crisis and means profits from the resultant offshore activities are not taxed in Australia).

4.5.28. Should the Government not want to implement Option B1, and does not want to implement Option A4, the Board makes the following comments for the Government to consider when weighing up the benefits and detriments of each approach.

No change to existing tax policy settings

4.5.29. Should the Government not wish to change existing tax policy settings other than to neutralise the hybrid mismatch, and does not at this time wish to address the broader financial system impediments caused by tax settings as noted in this report, then Option A3 would achieve this. However, this option is not favoured by the Board because it involves retention of a tax concession (section 215-10) intended to facilitate funding within an internationally competitive market that the Board understands is not often used in practice due to its commercially restrictive conditions and risk of non-compliance. Hence, retaining the existing tax settings under Option A3 may simply defer reforms that may need to be done in the future.

No carve out from the hybrid mismatch rules for regulatory capital

4.5.30. A number of stakeholders submitted that Australia should not apply the hybrid mismatch rules to regulatory capital. Australia has committed to implementing the hybrid mismatch rules and exceptions should only be granted where there is a compelling case to do so. The Board does not consider a sufficiently compelling case has been made to exclude regulatory capital from the application of the hybrid mismatch rules — for the reasons noted in section 4.4. The increased cost of capital to regulated entities as a proportion of their overall funding is not expected to be significant. Accordingly, the Board does not recommend Australia provide a carve out for regulatory capital (Option C).

Conclusion

4.5.31. The Board acknowledges that there may be some sensitivities associated with each of the options to neutralise hybrid mismatch arrangements.

4.5.32. Notwithstanding the potential for different perceptions or sensitivities about these options, the Board does not consider these concerns to be a sufficient reason to not recommend the option which provides optimal benefits. Option B1 (to make returns on AT1 deductible in Australia) delivers a solution which neutralises the hybrid mismatch and provides financial market and other economic benefits consistent with all of the terms of reference.

4.5.33. As noted above, the costing outcomes were factored into the process of weighing up the benefits and detriments of each option. However, there is no guarantee that the assumed behavioural responses will align with the actual behavioural responses.

4.5.34. In the Board's view, there should be additional benefits to the Australian economy or contribution to the stability of the financial system that outweigh any reduced income tax revenue collected from these options (noting that all of the options create revenue). However, this is ultimately a decision for Government.

4.5.35. A summary of the key recommendations made in this report regarding the application of hybrid mismatch rules to regulatory capital in Australia is set out in Appendix C.

4.5.36. For the reasons noted above and as further illustrated in Appendix D, the Board makes the following recommendations.

Recommendation 1

The Board's preferred option is Option B1 (to facilitate treatment of AT1 as debt for tax purposes).

Recommendation 2

If the Government does not at this time wish to implement Option B1, the option next preferred by the Board is Option A4 (to treat returns on AT1 as unfrankable where issued out of a foreign branch).

Recommendation 3

If the Government does not at this time wish to:

- implement either of options B1 or A4;
- change existing tax policy settings other than to neutralise the hybrid mismatch; nor
- address the broader financial system impediments caused by tax settings as noted in this report;

then Option A3 would achieve this (by applying the hybrid mismatch rules to render AT1 unfrankable where a deduction has been claimed in a foreign jurisdiction, but subject to existing section 215-10 restrictions). However, retaining the existing tax settings in section 215-10 may simply defer reforms which may need to be done in the future.

Chapter 5: Interactions with Australian Income Tax Law

5.1 Introduction

5.1.1 The taxation of regulatory capital instruments is governed by a combination of Australia's debt/equity rules, imputation rules, thin capitalisation regime, transfer pricing provisions and withholding tax rules.

5.1.2 The imputation rules include various integrity measures, including anti-streaming rules to prevent franking credit streaming to resident investors; and benchmark franking percentage rules requiring equal franking of all dividends paid within a specified time period.

5.1.3 The Board outlines below some interaction issues that are likely to arise upon application of the hybrid mismatch rules to regulatory capital. However, the Board recommends that the legislative design process provide the opportunity to consult with stakeholders to ensure any additional interaction issues may be identified.

5.2 Thin capitalisation

5.2.1 The Australian thin capitalisation rules are contained in Division 820 of the 1997 Act. Division 820 acts as an integrity regime designed to limit allowable debt deductions[77] taken by taxpayers on cross-border investments. This limit is set by applying a statutory ratio or formula, with special rules applying to ADIs.

5.2.2 The safe harbour threshold for ADIs requires the holding of average equity capital of at least 6 per cent of risk-weighted assets (excluding assets and equity capital attributable to offshore branches and controlled foreign equity). The thin capitalisation safe harbour threshold for ADIs was based on the minimum Tier 1 capital requirements under the Australian prudential standards (being 4.5 per cent of common equity and 1.5 per cent of AT1). From 1 January 2016, an ADI is also required for regulatory purposes to hold an additional capital conservation buffer of common equity equal to 2.5 per cent of risk-weighted assets (unless otherwise determined by APRA) and additional countercyclical buffer of common equity of between zero and 2.5 per cent of risk-weighted assets. Accordingly, most ADIs in Australia are well within the thin capitalisation safe harbour limits.

77 Defined to include interest and amounts in the nature of interest.

5.2.3 One issue raised in the consultation process is that the concept of equity capital for thin capitalisation purposes is based on tax equity, rather than equity for prudential standards. Therefore, if AT1 were to be treated as debt for tax purposes, it would no longer be included as equity capital for thin capitalisation purposes. However, due to the significant increase in common equity prudential requirements and the tendency for ADIs to hold capital buffers in excess of their prudential requirements, this is an issue that is expected to affect very few ADIs in practice.

Recommendation 4

The Board recommends that further consideration should be given by Treasury as to whether to adjust the thin capitalisation rules in the event that the Government chooses to treat AT1 as debt for Australian tax purposes.

5.3 WITHHOLDING TAX

5.3.1 Australia's dividend and interest withholding tax rules contain a number of exemptions from withholding tax. For example, there is an exemption from interest withholding tax for debt instruments that are publicly offered to 'unrelated' third parties.[78]

5.3.2 Relevantly to regulatory capital, subjecting distributions paid on AT1 to withholding tax would increase the cost of capital for ADIs and be contrary to the objectives of achieving competitive neutrality between Australian and foreign ADIs.[79] For this reason, currently section 215-10-compliant distributions are excluded from the obligation to levy dividend withholding tax.[80]

5.3.3 The Board is of the view that the ability of Australian regulated entities to compete for capital in international markets would be adversely affected if there was a requirement to withhold tax on distributions to non-resident investors. The Australian regulated entities would likely be required to bear the cost of the withholding tax rather than the non-resident investor. Providing a specific exemption from withholding tax for distributions on AT1 would encourage competitive neutrality and discourage AT1 being issued to Australian resident investors only.

Recommendation 5

The Board recommends that a specific exemption from withholding tax should exist for distributions on AT1 under all of the proposed 'A' or 'B' options, to enable regulated entities to compete in the international markets for capital.

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78 Section 128F of the Income Tax Assessment Act 1936 (public offer test exemption).

79 Paragraph 2.116 of the explanatory memorandum to *New Business Tax System (Debt and Equity) Bill 2001*.

80 Pursuant to paragraph 128B(3)(aaa) of the 1936 Act.

Franking credit streaming rules

5.3.4 Franking credit streaming involves selectively directing the flow of franked distributions to those members who can most benefit from franking credits.[81] The Australian income tax law contains numerous anti-streaming provisions.[82]

5.3.5 If either Option A1 or A4 were implemented based on an acceptance that the anti-streaming limitations of section 215-10 are not required, then further consideration would need to be given to the interaction with other anti-streaming measures in the tax law.

5.3.6 The Explanatory Memorandum to the Bill which introduced section 160APAAAA (the predecessor to section 215-10), made clear that section 177EA could still apply to cases of streaming; notwithstanding that a non-share equity interest was not frankable as a result of section 215-10.[83]

5.3.7 Therefore, an issue arises as to whether anti-streaming provisions can continue to apply to distributions that are made unfrankable as a result of the neutralisation of a hybrid mismatch outcome using options A1 and A4. However, there is precedence from the High Court decision in *Mills v Commissioner of Taxation 2012 ATC 20-360* that section 177EA will not necessarily apply to facts and circumstances which include an AT1 raising undertaken by an ADI.

5.3.8 On this basis, the Board recommends that franking credit streaming be considered further by Treasury should the Government proceed with the adoption of any of these 'A' options, in particular whether any of the anti-streaming provisions need to be switched off in relation to distributions on AT1.

5.3.9 These additional integrity concerns do not arise for Option B1.

Recommendation 6

The Board recommends that the interaction with the franking credit streaming integrity rules in section 177EA be considered further by Treasury should the Government proceed with the adoption of options A1 or A4.

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81 Explanatory Memorandum to *New Business Tax System (Imputation) Bill 2002*, paragraph 3.28.

82 Including the franking credit streaming anti-avoidance rules in section 177EA of the 1936 Act and the anti-streaming rules in Division 204 of the 1997 Act, among others.

83 Explanatory Memorandum to *New Business Tax System (Debt And Equity) Bill 2001, paragraph 2.117.*

CHAPTER 6: IMPLEMENTATION CONSIDERATIONS

6.1 INTRA-GROUP REGULATORY CAPITAL ISSUANCES

Background

6.1.1 The Action 2 Report indicates that countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise from intra-group hybrid regulatory capital. This option was provided to address concerns that a number of regulators, such as the US, increasingly require or encourage financial institutions (such as banks) to issue regulatory capital externally at the top holding company level and then downstream lend this to operating subsidiaries.

6.1.2 The UK legislation[84] provides a full exclusion, at least for now, from the hybrid mismatch rules for regulatory capital instruments issued by banks and insurers. UK HMRC did indicate that the UK Government will continue to review the regulatory capital position with any changes enacted through regulation at a later date if any integrity concerns eventuate. The UK government also indicated that serious complexities might arise from seeking to eliminate a hybrid mismatch for intra-group regulatory capital in terms of apportionment and tracing.[85]

Board's consideration

6.1.3 If Australia continues to treat AT1 as equity for tax purposes, an intra-group hybrid mismatch could arise where an Australian regulated entity raises AT1 at the parent level and on-lends the funds to a foreign subsidiary using a back-to-back AT1 (which may count towards a foreign subsidiary's regulatory capital in the foreign jurisdiction). In such a case, the returns on the AT1 could be deductible to the foreign subsidiary and non-assessable non-exempt income for the Australian parent entity.[86] This mismatch may be neutralised if Australia (applying recommendation 2.1) denies the exemption under sub-division 768-A or the foreign jurisdiction denies a deduction to the foreign subsidiary to the extent that the income for the parent income is non-assessable non-exempt. In this scenario, the Board does not consider a carve out for intra-group regulatory capital should be granted, as neutralising a hybrid mismatch in these circumstances should not result in any regulatory or commercial concerns sufficient to warrant such an exclusion.

84 The UK's '*Hybrid and Other Mismatches*' law is to take effect from 1 January 2017.
85 See UK 2014 consultation paper.
86 Under Subdivision 768-A of the 1997 Act.

6.1.4 On the other hand, if AT1 is treated as debt for Australian tax purposes, a different intra-group hybrid mismatch could arise where a parent entity is based in a jurisdiction such as the US or Canada which treat AT1 as equity for tax purposes. It is notable that groups with a US parent entity are required to raise AT1 in the US. The US parent entity may on-lend the funds to an Australian subsidiary — including by way of a back-to-back AT1.

6.1.5 Where returns on intra-group AT1 are deductible by the Australian subsidiary and exempt income for the US parent entity, there is a hybrid mismatch. This mismatch would be dealt with by Australia applying Recommendation 1 of the Action 2 Report to deny the deduction by the Australian subsidiary. The Board understands that at the time of this report, there are no AT1 on issue from any Australian subsidiary bank to a US parent.

6.1.6 The Board considers that it would not be appropriate to provide an exclusion from the hybrid mismatch rules for intra-group regulatory capital, regardless of whether AT1 is treated as tax debt or equity in Australia. Whilst there is some merit to providing an exclusion where a foreign bank group is required to raise regulatory capital at the parent level to pass down, this does not need to be passed down in the form of a hybrid instrument. Further, it was submitted during consultation that in practice this issue is not currently a concern in the Australian market.

Recommendation 7

The Board is of the view that Australia's hybrid mismatch rules should apply to intra-group regulatory capital.

6.2 Date of commencement

Background

6.2.1 In the 2016-17 Budget, the Government announced that the hybrid mismatch rules would apply to payments made on or after the later of 1 January 2018 or six months after the date of Royal Assent. The Board considers that the general start date for the hybrid mismatch rules should also apply for the application of the hybrid mismatch rules to regulatory capital.

Board's consideration

6.2.2 The Board considers that if the Government adopts one of the unfrankable 'A' or deductible 'B' options, the changed tax treatment should apply only to AT1 issued on or after the later of 1 January 2018 or six months after the hybrid mismatch legislation receives Royal Assent (consistent with the recommendation made by the Board in its earlier *Hybrid Mismatch Report*). This should give regulated entities sufficient notice of the expected change in tax treatment. An earlier application date could result in regulated entities having to undertake public issuances without the certainty of legislation, and disclosing the tax treatment in their prospectuses based on a press release.

6.2.3 As the 'A' and 'B' options are intended as the primary mechanism to eliminate hybrid mismatches for regulatory capital, the Board considers it appropriate to align the start date with the rest of the hybrid mismatch rules.

6.2.4 The transitional arrangements for this start date are discussed below.

Recommendation 8

The Board recommends that the start date for either the 'A' or 'B' option be aligned with the start date of the rest of the hybrid mismatch rules. As such, the change in tax treatment should apply from the later of 1 January 2018 or six months after the hybrid mismatch legislation receives Royal Assent.

6.3 GRANDFATHERING AND TRANSITIONAL ARRANGEMENTS

Background

6.3.1 The Board notes that the implementation of the either Option A or B will result in a different tax outcome for an investor and would likely trigger a change of law covenant under the contractual terms of existing AT1. This would typically allow the issuer to redeem and replace the instrument.

6.3.2 Stakeholders were of the view that any hybrid mismatch rules should be 'unequivocally prospective' in their operation and apply only to instruments issued on a date after the relevant legislation has been enacted by Parliament. In this respect, stakeholders stated that this transitional rule would provide an appropriate level of certainty about the status of instruments already on issue, avoid the difficulty and cost of potential refinancing for issuers and unintended impacts on investors.[87] Concerns were raised around the ability for the Australian retail market to absorb multiple concurrent issuances for new AT1 if grandfathering of existing AT1 arrangements was not granted, and the resultant impact on refinancing costs.

6.3.3 The Board understands that, as at the 30 June 2016 reporting period, there was approximately $7.3 billion of frankable AT1 recognised in regulatory capital issued from offshore branches (the UK and New Zealand) for which a foreign deduction is claimed (out of total AT1 issued by Australian regulated entities recognised in regulatory capital of approximately $35.7 billion).[88]

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87 See the joint submission by NAB, CBA, Westpac and Macquarie Bank. Grandfathering for regulatory capital was also supported in a number of other submissions including ANZ, IAG and KPMG.

88 APRA's '*Quarterly Authorised Deposit-taking Institution Performance*', '*Quarterly General Insurance Performance*', and '*Quarterly Life Insurance Performance*' publications for the June 2016 quarter. The total amount issued reflects the amount of Level 2 regulatory capital of ADIs and Level 1 regulatory capital of insurers on issue as at 30 June 2016. The total AT1 of $35.7 billion shown above reflects AT1 on

6.3.4 There are two separate aspects of this review which may require grandfathering:

(a) existing deductible/frankable AT1 issuances, which may no longer be frankable under Recommendation 2.1 of the OECD hybrid mismatch rules; and

(b) AT1 issued prior to the proposed start date of the 'A' or 'B' options, being the later of 1 January 2018 or six months after the hybrid mismatch legislation receives Royal Assent.

Board's consideration

Existing deductible/frankable AT1 issuances

6.3.5 As noted above, there are some strong arguments in favour of grandfathering existing deductible/frankable AT1 from the application of the hybrid mismatch rules. However, a concession to grandfather existing arrangements to protect investors and minimise market disruption should not extend to the protection of new arrangements issued in the intervening period in full knowledge of the Government's intention to neutralise hybrid mismatches.

6.3.6 Accordingly, the Board recommends that existing deductible/frankable AT1 be grandfathered, but the cut-off date for the grandfathering of existing AT1 issuances should be limited to those issued before the date of the announcement containing the Government's response to this report. This is intended to discourage issuances of deductible/frankable instruments in the transitional period; as such issuances would only be able to access hybrid treatment for a limited period of time and would put investors at risk of a change in tax treatment part way through the term of the instrument.

6.3.7 Further, grandfathering of existing treatment should only continue until the optional call date of that AT1 as disclosed in the prospectus for that instrument, whether or not the instrument is called.[89]

6.3.8 The implications are set out in the Board's recommendation below.

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issue, which is different to the total amount of AT1 available to absorb losses ($34.5 billion) shown in Table 1. The $35.7 billion total AT1 on issue amount also includes approximately $1.2 billion of AT1 which is not available to absorb losses; for example, where one regulated entity holds an AT1 instrument issued by another regulated entity.

89 Most of the retail AT1 issuances have a call date that is five years after the issue date.

Non-hybrid AT1 issuances before the 'A' or 'B' option start date

6.3.9 The Board considers that appropriate grandfathering is also required for any change in tax treatment of AT1 under the 'A' or 'B' options. It would be disruptive to the market to change the tax treatment of an existing issuance mid-way through its term, and the Australian retail market would arguably not be large enough to support demand for a simultaneous issuance of all existing AT1 on issue if the existing AT1 were redeemed.

6.3.10 For this reason, the Board suggests a clean cut-off date for the change in treatment, based on the date of issuance. The implications are set out in the Board's recommendation below.

Recommendation 9

The Board's recommendation for transitional arrangements for each measure is set out below.

Transitional rules for AT1 that create hybrid mismatch outcomes (AT1 issued from a foreign branch)

- Deductible/frankable AT1 issued before the announcement of the Government's response to this report should be grandfathered, by continuing to allow issuers to frank returns on the instrument until the optional call date of the instrument.
- Deductible/frankable AT1 issued after the announcement should not be grandfathered. Accordingly, returns on the instrument could only be franked up to the start date of the hybrid mismatch rules on 1 January 2018 (or six months after Royal Assent). Deductible returns paid after that date would be unfrankable.

Transitional rules for AT1 that do not create hybrid mismatch outcomes (AT1 issued from Australia)

- For AT1 that do not create a hybrid mismatch issued before the proposed start date of 1 January 2018 (or six months after Royal Assent), the existing equity tax treatment should apply until the optional call date of the instrument (with the requirement to frank returns retained, unless the conditions in section 215-10 are met).
- For AT1 issued after the proposed start date of 1 January 2018 (or six months after Royal Assent), the proposed change in tax treatment will apply to those instruments from the date of issue (that is, the 'A' or 'B' option tax treatment may apply to the instrument, where applicable).

Appendix A: Terms of Reference

A.1. The OECD released its final package of Base Erosion and Profit Shifting (BEPS) Action recommendations on 5 October 2015. As part of this package, the OECD released its Action 2 Report — *Neutralising the Effects of Hybrid Mismatch Arrangements* (Action 2 Report). The Action 2 Report sets out recommendations for countries to make changes to their domestic law to neutralise the effect of hybrid mismatch arrangements and includes changes to the OECD Model Tax Convention to address such arrangements.

A.2. The Board of Taxation (Board) provided their report to Government on the implementation of the OECD hybrid mismatch rules on 31 March 2016. This report identified that deductible/frankable arrangements that arise in relation to regulatory capital result in a hybrid mismatch and recommended a subsequent process to consider the appropriate policy response given the complexities and interactions involved.

A.3. Consistent with the Board's recommendation and the Government's commitment to implementing the Action 2 Report, the Board is asked to further examine how best to neutralise the hybrid mismatch arrangement identified in the Action 2 Report.

A.4. In determining how best to neutralise the hybrid mismatch arrangement involving regulatory capital, the Board should identify an implementation strategy that has regard to:

(a) Delivering on the objectives of eliminating double non-taxation;

(b) Capital regulatory requirements as enforced and set by Australian Prudential Regulation Authority;

(c) Fostering a level playing field internationally and within the Australian banking and insurance sector;

(d) Economic implications and potential market disruption;

(e) Compliance and administrative costs for taxpayers; and

(f) Interactions between Australia's existing domestic legislation, including with related tax laws.

A.5. The Board should conduct targeted consultation with relevant parties by drawing on its extensive links with tax professionals, key business groups and other relevant bodies. The Board should also work closely with Treasury and the Australian Taxation Office in finalising its advice.

A.6. Further, the Board's advice should utilise and build upon the work done as part of the Board's recent review of the broader Australian implementation of the hybrid mismatch rules.

A.7. The Board is requested to report to Government by end of July 2016 to enable the commencement of the hybrid rules to deductible/frankable arrangements to align with the proposed commencement date of the hybrid mismatch rules in Australia.

APPENDIX B: UNFRANKABLE 'A' OPTIONS

OVERVIEW

B.1. Recommendation 2.1 is an optional recommendation in the OECD's Action 2 Report that requires the payee jurisdiction to deny the payee a dividend exemption or equivalent tax relief to the extent a payment on a financial instrument is deductible to the payer. In its Hybrid Mismatch Report, the Board recommended implementation of recommendation 2.1 into Australia's domestic law.

B.2. As noted at paragraph 5.3.4, implementation of OECD recommendation 2.1 in Australia's income tax law would neutralise the hybrid mismatch outcome but may also give rise to franking credit streaming concerns whereby Australian regulated entities with foreign branches could choose to issue their unfrankable AT1 only to their foreign resident investors and their frankable AT1 to only their Australian resident investors. For the reasons outlined at paragraphs B.22 and 4.2.6 onwards, the Board does not consider franking credit streaming in relation to AT1 to be a material concern.

Streaming

B.3. The Board considered whether additional restrictions are required to prevent streaming of franking credits where Option A is adopted.

B.4. The Board looked at two potential options to deal with streaming:

- replace section 215-10 with a cap on the amount of AT1 that can be issued as unfranked (Option A2); and
- retain section 215-10 restrictions to limit the ability to stream franking credits (Option A3).

B.5. The Board also considered whether the risk of streaming was sufficient to justify application of either restriction, given the small amount of AT1 on issue relative to the overall funding of regulated entities, and the existing ability to apply Australia's various existing anti-streaming provisions to any such streaming.

Option A2: Unfrankable cap

B.6. Under this option, the hybrid mismatch rules would apply to prevent deductible/frankable structures by switching off the ability to frank an instrument that was deductible in another country. However, the amount that may be treated as unfrankable would be capped to a fixed percentage of AT1 (for example, 20 per cent or 35 per cent of all AT1).

B.7. Under this option, the cap would be a global cap applying to both the Australian regulated entity and its foreign operations. Therefore, unfrankable instruments (below the cap) may be issued either from Australia or a foreign branch. In practice, as a deduction would not be available in Australia for an unfrankable instrument, regulated entities are likely to issue predominately from foreign branches. However, the option would enable wholly domestic regulated entities the option to issue non-deductible/unfrankable instruments from Australia in times of crisis.

B.8. Unlike section 215-10, there would be no restriction on the place of issue or the use of the funds raised by the AT1. The unfrankable cap would replace section 215-10, thus continuing the existing policy of allowing a limited amount of streaming (limited to both the unfrankable cap, and the size of the foreign branch operations), but without the complexities and restrictions imposed by section 215-10.

B.9. Feedback from stakeholders was that caps are generally not a desired feature in tax law design. They can complicate capital raising choices where minimum issuances are commercially necessary, practically be difficult to administer, add to compliance costs and give rise to interaction issues. Notwithstanding this, some stakeholders indicated that if the only alternative option was retaining section 215-10, they would prefer the cap option.

B.10. Stakeholders did not have any suggestions for an appropriate level of cap.

B.11. If a cap were to be implemented, some stakeholders submitted that it should be the greater of a nominated percentage of AT1 and a fixed threshold amount representing the minimum capital raising size required for an AT1 issuance to be commercially viable (say, A$500 million). This is to ensure smaller regulated entities are not prevented from accessing the unfrankable cap by virtue of their size (for example, a cap equal to 35 per cent of issued AT1 for a smaller regulated entity may be too small to constitute a marketable issuance size).

B.12. One view submitted in consultation was that imposing any sort of cap would limit access to liquidity and may result in tax outcomes rather than economic outcomes dictating what amount of capital can be accessed by regulated entities (for example, where a regulated entity needs to pass on oversubscribed AT1 that it would, absent any income tax constraints, have accepted).

B.13. For the reasons noted above, the Board does not recommend capping unfrankable issuances.

Option A3: Retain section 215-10 restrictions

B.14. Under this option, AT1 returns would be unfrankable where the return was reasonably expected to be deductible in another jurisdiction, but with additional franking account consequences where the conditions in section 215-10 were not met (to prevent the ability to issue a deductible/frankable instrument through an offshore branch by bringing the funds back to Australia).

B.15. The regulated entity would be required to debit its franking account for AT1 returns on issuances through a foreign branch in a deductible jurisdiction, unless the conditions in section 215-10 were met. That is, AT1 issued from a deductible jurisdiction is only permitted to be unfrankable without a penalty debit to the franking account where the AT1 is issued from a foreign branch in a listed country, and the funds are used outside of Australia.

B.16. This option preserves the original intentions of section 215-10. Although it implements the hybrid mismatch rules to regulatory capital in a manner that is narrower than the Action 2 Report suggests, it requires the least departure from existing policy and therefore has the least potential for market disruption.

B.17. However, Option A3 does not achieve many of the other factors in the Board's terms of reference to the same extent as compared to the other options, and reinforces and relies upon existing section 215-10 provisions which have been identified as 'not working' by some stakeholders. Notwithstanding the ATO's more recent draft interpretative guidance on section 215-10, which was welcomed by industry, the feedback from stakeholders was that the provision is expected to remain difficult to use in practice and constrains the way that a regulated entity would commercially operate its business. One of the banks issued an unfrankable instrument using section 215-10 based on the ATO's revised interpretation during the consultation period but noted that it remains difficult to navigate. Therefore, it is not yet clear whether use of section 215-10 will increase significantly in the future. If it does not, this may continue to discourage regulated entities from diversifying their funding sources.

B.18. The Board notes that section 215-10 and its predecessor[90] were introduced with an aim of providing competitive neutrality for Australian ADIs seeking capital in international markets. Feedback from stakeholders on the difficulty of using this concessional provision in practice indicates that it has not successfully achieved this aim. Its limited use has meant a continued concentration in the Australian retail market, which as noted in paragraph 3.1.5 increases financial stability risk in Australia.

B.19. The Board observes that if section 215-10 were to be retained, further consideration should be given to amending the section to make it more workable in practice, and to extend its useability by removing the listed country requirement and extending its application to regulated insurance entities. There seems limited point in retaining section 215-10 in its current form if it is not achieving the purpose for which it was implemented.

B.20. However, it should be noted that maintaining the status quo by adopting option A3 may just be deferring reforms that will need to be done in the future. Any reform in this area is likely to bring into consideration the advantages and disadvantages of the other 'A' options discussed in this report.

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90 160APAAAA of the 1936 Act.

B.21. Where the Government does not wish to change existing tax policy settings other than to neutralise the hybrid mismatch, and does not at this time wish to address the broader financial system impediments caused by tax settings as noted in this report, then Option A3 would achieve this. However, this option is not favoured by the Board because of the reasons outlined above relating to the retention of section 215-10. It also creates difficulties by requiring the tracing of funds similar to Option A1. Therefore, retaining the existing tax settings under Option A3 may simply defer reforms that may need to be done in the future.

Allow streaming

B.22. As noted above, a direct application of recommendation 2.1 would enable regulated entities to stream franking credits (subject to application of Australia's various anti-streaming provisions). The working group examined the level of risk of this occurring.

B.23. There were a number of factors considered by the working group, which provided a natural cap on the level of streaming likely to take place if there were no restrictions put in place:

- feedback from a number of stakeholders suggested that even if regulated entities are given access to a wider investor base, the Australian domestic retail market is likely to still remain the cheapest source of funding most of the time. Accordingly, regulated entities could be expected to issue the majority of their AT1 as frankable AT1 to the domestic retail market, rather than as unfrankable AT1 through a foreign branch;
- APRA places limits on the exposure that an ADI may have to its foreign subsidiaries and related entities, thereby placing upper limits on the deductible/unfrankable AT1 issuances lent back to Australia via the foreign subsidiary (however this does not apply to loans from the branch to the Australian parent); and
- AT1 represents a small proportion of the overall funding requirements for ADIs and insurers. Due to the relatively expensive nature of AT1 relative to Tier 2 capital instruments, these entities are unlikely to issue significantly more AT1 than needed for prudential purposes to take advantage of streaming benefits.

B.24. Based on the above factors, the Board does not consider streaming to be a significant risk, and should not outweigh the benefits of encouraging diversity of funding.

'Issued outside Australia'

B.25. Option A4 (refer to paragraph 4.2.18) requires a linking to an issuance outside of Australia. As evidenced by the practical difficulties that have arisen for section 215-10, complexity can arise with determining the 'place of issue' for an instrument. Stakeholders submitted that the place of execution should be sufficient evidence for the place of issue. However, in interpreting section 215-10, the ATO have required additional activities to be undertaken in the foreign branch to evidence the place of issue.

B.26. The Board notes that the requirement to *'issue' a security outside Australia* was previously considered in Taxation Determination TD 1999/9 in relation to debentures under the old section 128F, which operated prior to 1 January 1996. The TD notes the observations of Justice Chitty in *Levy v. Abercorris Slate and Slab Company (1887) 37 Ch 260*, where he stated at 264:

> *" "issued" is not a technical term, it is a mercantile term well understood; "issue" here means the delivery over by the company to the person who has the charge".*

B.27. The TD concludes that:

> *… provided the relevant debenture is, in the case of a bearer debenture, executed and delivered outside Australia and, in the case of a registered debenture, executed and delivered outside Australia and registered on a register outside Australia, a company is taken to have issued a debenture for the purpose of paragraph 128F(1)(c).*

B.28. Accordingly, there is previous precedent which may inform the implementation of this option if desirable.

B.29. Further, it is acknowledged that some of this uncertainty could also be removed by a codification setting out the requirements to evidence the place of issue.

Integrity considerations

B.30. Under Options A1 and A4, the Board also considered whether integrity measures were required to prevent foreign branches lending back funds to their Australian parent entities, either directly through the branch or indirectly via an offshore subsidiary, thereby generating an interest deduction in Australia from funds sourced from AT1 issued out of the foreign branch. The Board notes that this is already possible under the current law and that there are existing integrity measures (for example, thin capitalisation and interest withholding tax) that prevent excessive use of this. Further, the Board notes there are related entity prudential restrictions on the amount of non-equity exposure a regulated entity may have between the regulated entity and foreign subsidiaries[91] (discussed at paragraph 2.1.9, although these restrictions do not apply to loans from the foreign branch back to the Australian parent).

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91 Refer APRA Prudential Standard, *Associations with Related Entities,* APS222.

B.31. For Option A4, as a further integrity measure it would also be necessary not to carve regulatory capital out of the general hybrid mismatch rules. This means that OECD recommendation 2.1 would still need to be able to apply to prevent any arbitrages between jurisdictions (to prevent a deductible/frankable instrument being able to be issued where the place of issuance is Australia but the funds are used offshore in a foreign jurisdiction that allows a tax deduction).

APPENDIX C: SUMMARY OF THE BOARD'S RECOMMENDATIONS

C.1. A summary of the Board's key recommendations made in this report regarding the application of hybrid mismatch rules to regulatory capital in Australia is as follows:

Recommendation 1

The Board's preferred option is Option B1 (to facilitate treatment of AT1 as debt for tax purposes)

Recommendation 2

If the Government does not at this time wish to implement Option B1, the option next preferred by the Board is Option A4 (to treat returns on AT1 as unfrankable where issued out of a foreign branch).

Recommendation 3

If the Government does not at this time wish to:

- implement either of options B1 or A4;
- change existing tax policy settings other than to neutralise the hybrid mismatch; nor
- address the broader financial system impediments caused by tax settings as noted in this report;

then Option A3 would achieve this (by applying the hybrid mismatch rules to render AT1 unfrankable where a deduction has been claimed in a foreign jurisdiction, but subject to existing section 215-10 restrictions). However, retaining the existing tax settings in section 215-10 may simply defer reforms which may need to be done in the future.

Recommendation 4

The Board recommends that further consideration should be given by Treasury as to whether to adjust the thin capitalisation rules in the event that it chooses to treat AT1 as debt for Australian tax purposes.

Recommendation 5

The Board recommends that a specific exemption from withholding tax should exist for distributions on AT1 under all of the proposed 'A' or 'B' options, to enable regulated entities to compete in the international markets for capital.

Recommendation 6

The Board recommends that the interaction with the franking credit streaming integrity rules in section 177EA be considered further by Treasury should the Government proceed with the adoption of any of options A1 or A4.

Recommendation 7

The Board is of the view that Australia's hybrid mismatch rules should apply to intra-group regulatory capital.

Recommendation 8

The Board recommends that the start date for either the 'A' or 'B' option be aligned with the start date of the rest of the hybrid mismatch rules. As such, the change in tax treatment should apply from the later of 1 January 2018 or six months after the hybrid mismatch legislation receives Royal Assent.

Recommendation 9

The Board's recommendation for transitional arrangements for each measure is set out below.

Transitional rules for AT1 that create hybrid mismatch outcomes (AT1 issued from a foreign branch)

- Deductible/frankable AT1 issued before the announcement of the Government's response to this report should be grandfathered, by continuing to allow issuers to frank returns on the instrument until the optional call date of the instrument.
- Deductible/frankable AT1 issued after the announcement should not be grandfathered. Accordingly, returns on the instrument could only be franked up to the start date of the hybrid mismatch rules on 1 January 2018 (or six months after Royal Asset). Deductible returns paid after that date would be unfrankable.

Transitional rules for AT1 that do not create hybrid mismatch outcomes (AT1 issued from Australia)

- For AT1 that do not create a hybrid mismatch issued before the proposed start date of 1 January 2018 (or six months after Royal Asset), the existing equity tax treatment should apply until the optional call date of the instrument (with the requirement to frank returns retained, unless the conditions in section 215-10 are met).
- For AT1 issued after the proposed start date of 1 January 2018 (or six months after Royal Asset), the proposed change in tax treatment will apply to those instruments from the date of issue (that is, the 'A' or 'B' option tax treatment may apply to the instrument, where applicable).

APPENDIX D: ANALYSIS OF THE TERMS OF REFERENCE SATISFIED BY THE OPTIONS CONSIDERED

Each of the Options considered is measured against the terms of reference to assess which options will achieve and best achieve those terms of reference. The following Key assists to understand the assessment made:

Key
Likely to achieve/support the relevant Term of Reference
Likely to partially achieve/support the relevant Term of Reference
Likely to not achieve/support the relevant Term of Reference
Uncertain whether the relevant Term of Reference will be achieved/supported

	AT1 is deductible in Australia (B1)	AT1 is unfrankable if: - deductible in branch (A1), or - issued out of a foreign branch (A4)	AT1 is unfrankable if deductible in branch, but only up to a cap (A2)	AT1 is unfrankable if 215-10 requirements are met (A3)	Carve out for regulatory capital (C)
Eliminates double non-taxation	Yes	Yes	Yes	Yes	Not necessarily — relies on foreign jurisdiction to implement hybrid mismatch rules
Regulatory capital requirements — Encourages diversity of funding sources	Yes — gross pay attractive to wholesale domestic and international capital raisings (as well as domestic retail)	Yes — gross pay attractive to wholesale domestic and international capital raisings (as well as domestic retail)	Yes, but limited to cap	Status quo — limited to the size of the branch operations	No — frankable issuances will encourage domestic retail issuances

	AT1 is deductible in Australia (B1)	AT1 is unfrankable if: - deductible in branch (A1), or - issued out of a foreign branch (A4)	AT1 is unfrankable if deductible in branch, but only up to a cap (A2)	AT1 is unfrankable if 215-10 requirements are met (A3)	Carve out for regulatory capital (C)
Regulatory capital requirements — Resolution risk (encourage capital raising at parent)[92]	Likely yes — encourages capital to be raised at Australian parent rather than foreign branch	Likely no — hybrid issuances from foreign branch discouraged, but will encourage non-hybrid unfrankable capital to be raised from foreign branch (as no restriction on use of funds)	Partial — hybrid issuances from foreign branch discouraged, but will encourage some encourage non-hybrid unfrankable capital to be raised from foreign branch but impact is limited to cap	Partial — hybrid issuances from foreign branch discouraged, but will encourage some capital to be raised from foreign branch but impact is limited by s215-10 restrictions	Possibly — if foreign jurisdiction does not eliminate hybrid mismatch then foreign branch hybrid issuances will continue
Fostering a level playing field — internationally	Yes — AT1 is deductible in most other jurisdictions. International investors are attracted to gross-pay returns	Yes — but only for regulated entities with foreign branches (for A1 and A4)	Yes — but limited to cap	Status quo — for ADIs with foreign branches only (s215-10 restriction)	Status quo — for ADIs with foreign branches only (s215-10 restriction)
Fostering a level playing field — domestically	Yes — AT1 is deductible for all regulated entities regardless of foreign branch operations or ADI status	No — wholly domestic entities cannot access (for A1 and A4)	No — wholly domestic entities cannot access	Partial — wholly domestic entities cannot access (but funds can only be used in offshore operations)	Possibly — may be a more level playing field if foreign jurisdiction denies deduction

92 Resolution risk is about the risk of assets being seized. If the parent bank chooses to conduct mobile activities that generate assets in the branch jurisdiction, a resolution risk would arise. Conversely if the bank branch chooses to conduct mobile activities that generate assets in the parent's jurisdiction, a resolution risk would equally be unlikely.

	AT1 is deductible in Australia (B1)	AT1 is unfrankable if: - deductible in branch (A1), or - issued out of a foreign branch (A4)	AT1 is unfrankable if deductible in branch, but only up to a cap (A2)	AT1 is unfrankable if 215-10 requirements are met (A3)	Carve out for regulatory capital (C)
Economic Implications — Cost of funding	This option allows the regulated entity to raise capital in whichever market is cheapest — domestic or overseas. Neutralisation of hybrid mismatch will increase cost of capital, but increased wholesale investor participation may improve liquidity and pricing	This option allows the regulated entity to raise capital in whichever market is cheapest — domestic or overseas. Neutralisation of hybrid mismatch will increase cost of capital, but increased wholesale investor participation may improve liquidity and pricing	This option allows the regulated entity to raise (limited) capital in whichever market is cheapest — domestic or overseas. Neutralisation of hybrid mismatch will increase cost of capital, but limited/capped diversity of funding sources may help offset	This option allows the regulated entity to raise (limited) capital in whichever market is cheapest — domestic or overseas. Neutralisation of hybrid mismatch will increase cost of capital, with limited diversity of funding sources to offset due to s215-10 restrictions (worse than B1, A1and A4)	Status quo
Economic Implications — Risk for retail investors	Greater investor diversity may decrease concentration of investor risk in the Australian retail market	Greater investor diversity may decrease concentration of investor risk in the Australian retail market	Partial — allows for some greater investor diversity (up to cap)	Partial — limited to the size of the branch operations and s215-10 difficulties	No change
Compliance and administrative costs	Easy to implement (regulation) and comply	A1 — Potentially more difficult to comply, subject to legislative design A4 — potentially easier to implement and comply, subject to legislative design	Easier to comply than s215-10, subject to legislative design (but caps still may be difficult)	More difficult (known s215-10 difficulties remain)	More difficult (known s215-10 difficulties remain)
Provides tax certainty	Yes	Some — but subject to outcome in foreign jurisdiction (A1) A4 — likely to provide more tax certainty than A1	Some — but subject to outcome in foreign jurisdiction	No — Need ATO ruling and 215-10 requirements difficult to comply with	No certainty until foreign jurisdiction responds

	AT1 is deductible in Australia (B1)	AT1 is unfrankable if: - deductible in branch (A1), or - issued out of a foreign branch (A4)	AT1 is unfrankable if deductible in branch, but only up to a cap (A2)	AT1 is unfrankable if 215-10 requirements are met (A3)	Carve out for regulatory capital (C)
Interactions with Australia's domestic tax law	Thin capitalisation interactions	Allows streaming, but minimal interaction provisions required	Will need additional integrity rules to deal with breaches of the cap	Closest to existing policy position (which may or may not be appropriate) Section 215-10 has problems Requires additional tax integrity measures to ensure s215-10 interactions are appropriate	No change

APPENDIX E: GLOSSARY

1936 Act	*The Income Tax Assessment Act 1936*
1997 Act	*The Income Tax Assessment Act 1997*
AASB	Australian Accounting Standards Board
Action 2 Report	OECD's: *Neutralising the Effects of Hybrid Mismatch Arrangements of the BEPS Action Plan*
ADI	Authorised Deposit-taking Institution
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
AT1	Additional Tier-1 capital instruments
ATO	Australian Taxation Office
Basel III capital Reforms	December 2010 published Basel Committee reforms
BEPS	Base Erosion and Profit Shifting
CET1	Common Equity Tier 1 capital instruments
D/NI	Deduction/No Inclusion
HMRC	HM Revenue & Customs
Hybrid Mismatch Report	Implementation of the OECD Hybrid Mismatch Rules
NZ	New Zealand
NZ IRD	New Zealand Inland Revenue Department
OECD	Organization for Economic Co-operation and Development
Option A1	Refer to paragraph 4.2.10
Option A2	Refer to paragraph B.6
Option A3	Refer to paragraph B.14
Option A4	Refer to paragraph 4.2.18

Option B1	Refer to paragraph 4.3.2
Option B2	Refer to paragraph 4.3.7
Option C	Refer to section 4.4
The Board	Board of Taxation
Tier 2	Tier 2 capital instruments
UK	United Kingdom
US	United States