23 May 2014

Review of the Debt & Equity Tax Rules
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
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By email: taxboard@treasury.gov.au

Dear Review Team

The Customer Owned Banking Association (COBA) appreciates the opportunity to comment on the debt and equity rules in the income tax law and related issues for customer-owned banking institutions concerning:

- franking credits and competitive neutrality; and
- regulatory capital under Basel III.

Customer-owned banking

COBA is the industry body for Australia's 83 credit unions, 10 mutual banks and 7 mutual building societies. These institutions serve more than four million Australians, have $86 billion in total assets and collectively rank fifth behind the four major banks in share of the household deposits market.

Our sector is characterised by strong balance sheets, conservative business models, strong customer loyalty and community involvement. The strengths of our sector are strengths for the financial system, contributing to stability and genuine consumer choice.

Our members are Authorised Deposit-taking Institutions (ADIs) under the *Banking Act 1959* and public companies and Australian Financial Services Licensees under the *Corporations Act 2001*.

Customer-owned banking institutions exist solely to serve their customers and do not face the conflict of listed banking institutions where customers' interests must come second to the interests of shareholders.

This distinction between business models is important to note in the context of a review of the debt and equity tax rules because the taxation regime does not adequately accommodate the customer-owned model.

The Review's *Discussion Paper* quotes the Explanatory Memorandum that accompanied the New Business Tax System (Debt and Equity) Bill 2001 setting out why Division 974 was intended to reflect the economic substance of an interest.

> "The income tax law provides a tax treatment of returns to the shareholders of a company which differs from the tax treatment of returns to its creditors (debt holders) … This differential tax treatment is fundamental to the tax law. It

> recognises the fundamental difference between the equity holders of a company, who take on the risks associated with investing in the activities of the entity, and its creditors, who, as far as possible, avoid exposure to the risks … In recognising this fundamental difference, it is essential that the tax law draws the borderline separating the 2 (the debt/equity border) in such a way that the legal form of an interest cannot be used to result in a characterisation at odds with its economic substance."

In the case of customer-owned banking institutions, there is no fundamental difference between the equity holders of the company and the creditors. The creditors of a customer-owned banking institution, i.e. its depositors, are also the equity holders because they, along with the institution's borrowers, are the company's owners.

Franking credits & competitive neutrality

Customer-owned ADIs generally do not pay dividends because they are not companies run for the purpose of yielding a return to shareholders (as set out in Part 5, Schedule 4 of the Corporations Act 2001[1]). Customer-owned ADIs rely on retained earnings as their main source of regulatory capital to meet prudential standards and support growth.

Although customer-owned ADIs are not motivated to maximise profits, it is important that they are profitable. This means that customer-owned ADIs pay company tax and accumulate franking credits.

Where a customer-owned ADI does issue share-like securities to diversify its capital base and to pay dividends, it is restricted (under the principles of mutuality expressed in ASIC Regulatory Guide 147) to distributing no more than 50 per cent of its annual profit in dividends.

An important principle of competitive neutrality is that competitors should be subject to the same effective tax burden. This is not the case for customer-owned banking institutions compared to their listed competitors.

Customer-owned ADIs pay company tax at the standard 30 per cent rate but their reliance on retained earnings as their main source of regulatory capital makes it difficult for them to release franking credits.

Under the franking credits system, company tax is essentially a withholding tax with the final tax due on a company's distributed profits being determined by the marginal tax rate of the underlying shareholders. The total tax paid on company earnings can be lower than the corporate tax rate if the average marginal tax rate of a company's shareholders is below the corporate tax rate.

Where an organisation is unable to pay out earnings and franking credits to its owners, the average tax rate is the company tax rate. This is the case for customer-owned banking institutions. The average tax rate for listed banking institutions is lower because the average marginal tax rate of their shareholders is below 30 per cent.

The franking credits regime does not contemplate companies that pay tax but then retain, rather than distribute, after-tax profits as a core feature of their business model.

Customer-owned ADIs should be able to pass on to their owners the benefit of having paid company tax, just as non-mutual companies can choose to do. As noted above, dividend imputation means company tax is a pre-payment of tax ultimately paid by the company's owners. Owners of companies that pay dividends are able to benefit from the

[1] http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/sch4.html

tax paid by the company through a reduction in their personal taxation liabilities. Owners of companies that don't pay dividends, such as customer-owned ADIs, are not able to benefit in this way. For customer-owned ADIs, franking credits remain locked up, increasing year after year as the company continues to make profits, pay tax and prudently retain those profits as its main source of regulatory capital.

Customer-owned banking institutions collectively have accumulated franking credits of more than $1.5 billion and are adding $150-200 million per year. In the year ending June 2013, customer-owned banking institutions collectively made a pre-tax profit of $629 million, paying company tax of $185 million.

Solutions to the unfair company tax burden on customer-owned ADIs include:

- allow customer-owned ADIs to issue a frankable debt deposit product; or
- apply company tax on customer-owned ADIs at a rate that is comparable to the effective tax rate of their listed competitors.

The option of a frankable debt deposit product involves an otherwise ordinary deposit product but the interest paid would include a distribution of franking credits that could be used by the depositor to credit against tax payable on the interest. To give effect to this option, tax law would need to be amended to allow customer-owned ADIs to pass on franking credits to their members.

Generally speaking, distributions on an instrument are frankable or deductible, but not both.

Legislative change would be needed to allow customer-owned ADIs to issue a frankable debt deposit product. This would involve amending the definition of a non-share equity interest in the income tax law. A non-share equity interest is typically legal form debt which has equity characteristics and is frankable. The definition would be amended to include a debt interest that is a deposit in a customer-owned ADI with a minimum term of not less than, say, 12 months. This would mean that interest payments on an eligible deposit would be frankable. For a customer-owned ADI to be able to deduct these interest payments, a further amendment to the tax law would be required. Currently, non-share distributions are non-deductible.

Some financial institutions have found ways to issue instruments with distributions that are deductible and frankable, by issuing the instrument through an overseas branch as debt but marketing the instrument domestically as equity. This has attracted the attention of the Australian Tax Office (ATO) which has sought to bring anti-tax avoidance provisions to bear. Commonwealth Bank (CBA) issued securities (PERLS V) in New Zealand, obtaining a deduction in New Zealand, but offering Australian residents the imputation benefit. The ATO and CBA fought this through the Federal Court and the High Court and ultimately CBA won the case. The High Court found against the Tax Commissioner and allowed CBA to make franked distributions on PERLS V securities, partly because the fact the distributions on the CBA notes were deductible in New Zealand was held not to be relevant. In any case, such a structure is not available to customer-owned ADIs.

The alternative option to creating a new frankable debt instrument is to give customer-owned ADIs a company tax rate that is comparable to the effective tax rate of listed banks.

COBA commissioned the Australian Centre for Financial Studies (ACFS) to produce an independent report on the tax treatment of customer-owned ADIs compared to their listed competitors. The report, *Equitable Taxation of Customer Owned Banking*[2], found:

[2] COBA submission to Financial System Inquiry, Attachment B http://www.customerownedbanking.asn.au/policy/submissions)

> "While mutual ADIs are obliged to pay company tax, they do not distribute profit by way of dividends on risk capital, except in some limited circumstances subject to an 'economic relationship test' and 'governance relationship test' set out in ASIC Regulatory Guide 147 *Mutuality – Financial institutions*. Earnings are retained as inter-temporal equity to meet capital requirements and serve the needs of their current and future owner-members. Consequently, the franking credits applying to company taxes paid are accumulated rather than distributed. Hence, as at February 2013, mutual ADIs had accumulated approximately $1.5 billion in franking credits which, due to the general absence of risk capital, cannot be passed on to the ADIs' owners.
>
> "Under the franking credit system, company tax is essentially a withholding tax with the final tax due on a company's distributed profits being determined by the marginal tax rate of the underlying shareholders. Prior to the introduction of rebates in July 2000, franking credits received by investors that could not offset a tax liability remained unused, meaning the company tax rate acted as a lower bound for the effective tax rate on company earnings. With the introduction of cash rebates on unused franking credits, the total tax paid on company earnings can be lower than the corporate tax rate if the average marginal tax rate of a company's shareholders is below the corporate tax rate. Of course, when an organisation is unable to pay out earnings and franking credits to investors, the average tax rate becomes the company tax rate."

According to the ACFS report, the average effective tax rate on the earnings of the major Australian banks is well below the 30 per cent rate paid by customer-owned ADIs. The report calculates the average effective tax rate on the earnings of Australian major banks is between 22.15 per cent and 25.5 per cent.

> "This is below the corporate tax rate that applies to mutual ADIs that are unable to distribute franking credits. This discrepancy in effective tax rates creates an uneven playing field and may distort decisions of Australian depositors and borrowers."

While a change to the company tax rate would be one way to address the disparity around franking credits going forward, it would not address the significant build-up of franking credits which already exist within the customer-owned banking sector. For this reason, we believe the stronger policy response remains the introduction of a frankable debt deposit product, given that this will provide a solution around both existing and prospective franking credits.

<u>Recommendation:</u> *Provide equitable tax treatment of franking credits for the customer-owned model by allowing institutions to issue a frankable debt deposit product.*

Basel III capital Tier 2 instruments

Customer-owned ADIs are subject to the new Basel III capital regime implemented in Australian by APRA from 1 January 2013.

One of the key changes to capital framework is the requirement for Additional Tier 1 (AT1) and Tier 2 (T2) capital instruments to be written-off or converted to ordinary shares if relevant loss absorption or non-viability provisions are triggered.

APRA recently amended *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111) to better accommodate the customer-owned model. Because conversion into ordinary shares is not possible for mutual ADIs due to their mutual corporate structure, the revised APS 111 introduces the concept of 'mutual equity interests' (MEI) as the conversion option for mutual ADIs.

The alternative to conversion in a trigger event is write-off.

Customer-owned ADIs issuing T2 capital instruments, i.e. subordinated debt, may prefer write-off, rather than conversion, as the primary loss absorption mechanism for the instrument.

This is because it is less complicated and less costly for a mutual to issue a debt instrument than an equity-like instrument, either primarily as AT1 or in a 'trigger' event as MEI.

However, T2 instruments with write-off as the primary loss absorption mechanism have a significant handicap. APS 111 says for such instruments, "the amount recognised must account for potential taxation liabilities or other potential offsets at the time of issuance [and] adjustments must be updated over time to reflect the best estimates of the offset value."

APRA's requirement that the issuer must account up front for "potential taxation liabilities" means the amount of capital counted can be reduced by up to 30 per cent.

Moody's Investor Services commented on this issue in a recent note '*Mutual Equity Interests increase appeal of capital securities for Australian mutuals.'*

> "We see the creation of MEIs as key step towards levelling the playing field between mutuals and listed Authorised Deposit-taking Institutions (ADIs, which can issue common equity), in terms of the capital benefit they derive from Basel III compliant securities.
>
> "Under Basel III, new capital-qualifying securities can impose losses on investors, if and when the PONV [point of non-viability] is reached, either by conversion into common equity or through a write-down. However, from a capital efficiency perspective, a write-down is the inferior option in Australia as the gain from the write-down is taxable, thus reducing the potential capital benefit of the instrument by the amount payable in tax. This explains why all the Basel III securities issued to date by Australian banks have opted for conversion into equity as the primary form of loss absorption.
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> "The creation of MEIs thus gives mutuals the option to issue capital instruments that convert to MEIs – an alternative form of equity – without which they would be limited only to issuing securities with write-down features. As noted above, the capital benefit of Basel III securities with write-down features is reduced by the amount taxable, meaning that mutuals would need to issue a greater amount of write-down securities to get the same capital benefit as listed Australian banks, whose securities convert into equity."

A regulation[3] has already been made to facilitate debt tax treatment of Basel III compliant T2 securities. The regulation provides that an obligation to pay the principal or interest on a relevant capital instrument that contains the non-viability condition is not precluded from being a non-contingent obligation and therefore the capital instrument is not precluded from being a debt interest.

However, a further amendment to the law is needed to remove any potential tax liabilities for the issuer from the write-off of a Tier 2 instrument in a trigger event.

This is the approach that has been taken in the UK. The UK Government has introduced a regulation that took effect on 1 January 2014 to provide "certainty of tax treatment" for issuers of AT1 and T2 instruments.

[3] Income Tax Assessment Amendment Regulation 2012 (No.2)

The Explanatory Memorandum to the UK Taxation of Regulatory Capital Securities Regulations 2013[4] says:

> "These Regulations make provision for the new type of AT1 and T2 securities to which the regulations apply ('regulatory capital securities') to be taxed as debt and so provide credit institutions and investment firms with certainty of tax treatment to ensure that tax uncertainty does not discourage these entities from issuing more loss absorbent forms of capital."
>
> "…specific rules provide that...no credits or debits are brought into account in relation to certain conversions, write-downs and subsequent write-ups of the security arising as a result of a bank, investment firm or building society breeching a regulatory trigger or nearing insolvency. This will reduce potential tax burdens where an entity is in financial difficulty."

This approach should be adopted in Australia to facilitate issuance of Tier 2 instruments where write-off is the primary loss absorption mechanism at the point of non-viability. This will encourage a wider range of regulatory capital securities issued by ADIs, providing greater choice for investors and level the playing field for customer-owned ADIs that wish to raise capital without issuing equity-like instruments.

Recommendation: *Remove potential taxation liabilities for the issuer of a Tier 2 capital instrument arising from the write-off of a Tier 2 capital instrument in a non-viability trigger event.*

I can be contacted on 02 8035 8448 to discuss any aspect of this submission.

Yours sincerely

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[4] http://www.legislation.gov.uk/uksi/2013/3209/memorandum/contents