Australian Securitisation Forum

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The Treasury, Langton Crescent, Parkes ACT 2600

By email: [redacted]

Dear [redacted]

Proposed hybrid mismatch rules: impact on Australian securitisation industry

Thank you for the opportunity to make this submission in respect of the proposed hybrid mismatch rules. The Australian Securitisation Forum (ASF) is the peak industry body representing the Australian securitisation and covered bonds markets. The ASF goals are to facilitate the formation of industry positions on policy and market matters, represent the Australian industry to local and global policymakers and regulators and to advance the professional standards of the industry through a comprehensive suite of educational courses and workshops.

Summary

The Commonwealth Government has released its second exposure draft of legislation designed to implement the OECD's hybrid mismatch rules. Contrary to the OECD's recommendation, and the recommendation of the Board of Taxation report, no provision has been made to exclude securitisation vehicles from the operation of the hybrid financial instrument rule.

Without this exclusion, it is likely that many investors from the global capital markets will favour investing in securities which are issued in jurisdictions other than Australia or will demand higher returns to invest in equivalent Australian securities. The proposed rules will put Australian securitisations at a disadvantage compared to those in other jurisdictions who adopt the OECD recommendation 1.5.

More specifically the hybrid mismatch rules depend on the operation of foreign tax laws, which in the proposed terms would take into account the laws of any foreign country in which investors in a securitisation vehicle are resident at the time of each payment and can in many cases create a significant tax risk for all investors in that vehicle which cannot be mitigated by the issuer. Under the current proposal, in many securitisation transactions the return of a particular investor will be subject to the tax position of other investors at both the time of investing and throughout the term. That is, the return will be dependent on both the composition of other investors and the tax laws from time to time in other jurisdictions, neither of which a particular investor will be able to predict or control.

Further, the non-exception of securitisation vehicles will introduce a compliance burden on sponsors and funders to Australian securitisation transactions that will hamper the continued growth of the sector.

Securitisation is an important part of our finance industry currently with outstanding securities in excess of A$100 billion (not including non-public securitisations). It provides a key component of funding for non-ADI lenders and smaller ADI's without which they cannot compete against the larger Australian banks[1]. We submit that it is generally a low-risk industry from a tax perspective, as securitisation transactions are commercially driven transactions that allow borrowers to obtain diverse or low-cost funding from the capital markets. Tax neutrality of securitisation is a domestic tax policy objective which is threatened by the current proposal.

The ASF requests that a securitisation exemption be adopted, as recommended by the OECD.

Background

In October 2015, the OECD/G20 Base Erosion and Profit Shifting Project published its final report on *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2* (the **OECD Report**). The purpose of the report was to combat arrangements that use differences in the tax treatment of an instrument or entity between jurisdictions to achieve double non-taxation. Broadly, the OECD made a series of recommendations that the domestic tax treatment of instruments or entities should be made dependent upon their tax treatment in overseas counterparty jurisdictions.

Of particular relevance is Recommendation 1, which recommends that "hybrid financial instrument" rules be adopted, which would provide that the deductibility of a payment by an Australian entity in respect of a financial instrument should be made conditional upon that payment being taxable in the recipient's home jurisdiction.

However, Recommendation 1.5 in the OECD Report suggests that securitisation vehicles be excluded from the hybrid financial instrument rule in the payer jurisdiction, in order to preserve the tax neutrality of the vehicle; instead, any hybrid mismatch should be neutralised in the payee jurisdiction. The key passages of the OECD's recommendation and explanatory material are contained in the Appendix.

In March 2016, the Commonwealth Government published the Board of Taxation's report to the Treasurer entitled Implementation of the OECD Hybrid Mismatch Rules (the **Board Report**). Recommendation 9 in the Board Report was that further consideration should be given to

[1] Charles Littrell, Executive General Manager, APRA, *Prudential Reform in Securitisations*. ASF, Sydney, 11 November 2013, p2-3

legislating the exception for securitisation vehicles in Recommendation 1.5 of the OECD Report. We are not aware of any subsequent consultation being undertaken with the securitisation industry in relation to this issue.

The draft legislation in Australia

The Government has now released its second exposure draft of legislation designed to implement the OECD's hybrid mismatch rules: the *Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2018* (the **Second Exposure Draft**). The **Explanatory Memorandum** to the Second Exposure Draft (the Explanatory Memorandum) describes the Bill as closely following the recommendations made in the OECD Report, albeit making some alterations in order to take into account the unique features of the Australian tax system and the subsequent recommendations of the Board Report.

Subdivision 832-C of the Second Exposure Draft provides for the implementation of Recommendation 1 of the OECD Report, but makes no reference to the securitisation exclusion recommended by the OECD in Recommendation 1.5. No explanation has been given in the Explanatory Memorandum for the absence of Recommendation 1.5, nor any indication that further consideration of the issue has occurred in accordance with the Board of Taxation's recommendation.

Australia has an existing policy of tax neutrality for securitisation vehicles

The absence of Recommendation 1.5 also cannot be explained by reference to any unique feature of the Australian tax system. The OECD writes (at paragraph 102 of the OECD Report) that the securitisation exception should apply where the regulatory and tax framework in the establishment jurisdiction has the effect that the financial instruments issued by the investment vehicle will result in all or substantially all of the income of the vehicle being paid and distributed to holders within a reasonable period of time and where the tax policy of the establishment jurisdiction is that such payments will be subject to tax in the hands of investors.

The exception to the financial instrument rule set out in Recommendation 1.5 is intended to protect the tax neutrality of these vehicles while ensuring that they cannot be used to defer or avoid tax at the level of the payee.

Securitisation vehicles in Australia are generally established as wholly debt-funded vehicles whose capital is deployed to acquire a portfolio of income producing assets to support the debt issued by the vehicle. As a general proposition, substantially all of the collections received by the vehicle are used to pay interest and principal on debt issued by the vehicle, with a narrow margin being retained by the sponsor. From a tax perspective, full distribution of its income in respect of notes results in the securitisation vehicle being subject to no or minimal tax, reflecting the need for a tax neutral treatment for these vehicles. A non-tax neutral outcome would generally render the vehicle unviable, as there would be insufficient funds available to service debt obligations.

This need for tax neutrality is specifically contemplated as a policy matter in our domestic legislation, particularly through the availability of concessional thin capitalisation treatment for insolvency remote special purpose vehicles and securitisation vehicles (refer to sections 820-39 and 820-942 of the *Income Tax Assessment Act 1997*). These concessions are necessary because thin capitalisation rules would otherwise prevent a securitisation vehicle from being established in a tax neutral manner.

Section 820-39 was introduced by the *Taxation Laws Amendment Act (No. 5) 2003*, the Revised Explanatory Memorandum to which explained the need for specific rules covering "bona fide securitisation vehicles" to ensure their interest deductions are not "inappropriately" denied. Such reasoning remains applicable in considering the hybrid financial instrument rule. In particular, the Revised Explanatory Memorandum stated:

> 1.5 This treatment reflects that securitisation vehicles are tax neutral entities established to pool assets and are generally funded entirely through the issue of debt interests without the need to hold equity.
>
> 1.6 The securitisation industry is complex and dynamic. Many securitisation programs are not able to avail themselves of the benefits of the zero capital treatment provided under the current thin capitalisation legislation. In particular, the current definitions do not contemplate origination, warehousing, two-tiered securitisation or synthetic securitisation. Nor do the current rules allow any residual equity holding in a securitisation vehicle. As a consequence, many bona fide securitisation vehicles will inappropriately have a proportion of their interest deductions denied under the thin capitalisation rules.

As the vehicle will be tax neutral, tax will instead be levied at the noteholder level. This would either be Australian income tax (for an Australian holder), or it may be foreign income tax. There is generally no treaty-prescribed exemption from taxation for foreign holders under any of Australia's tax treaties.

Although securitisation transactions are highly "structured" in the sense that they are complex transactions subject to precise financial modelling, they are commercial transactions that are not designed to achieve the hybrid outcomes to which the draft legislation is directed.

Impact on industry

If the Second Exposure Draft is enacted as currently drafted, it will in many securitisation transactions create a significant tax risk for all investors in the vehicle and a corresponding demand for greater returns or a flight from the Australian securitised vehicle structure altogether.

This is because the impact of non-deductibility under the hybrid financial instrument rule may result in an elevated tax liability in the vehicle, and a depletion of funds available to service debt. The impact of the tax liability will therefore be spread across all investors in the vehicle, not just those which reside in countries where the tax laws create a deduction/non-inclusion mismatch. Such a risk cannot be remedied by any undertaking of the issuer since the analysis of the investors' jurisdictions of residence and the applicable tax laws must be carried out before each payment, and the analysis could change from payment to payment due to either:

- a change in a certain investor who sells its holding to another investor;
- a change in residence of certain investors; or
- a change in the tax laws of the countries in which certain investors reside.

While an investor may be aware of the relevant tax laws of its own country, this rule subjects them to the actions of all other investors and to the tax laws of every other country in the world, regardless of whether that country is enacting BEPS-related laws or has similar mismatch rules to these. Understandably, investors will either refuse to accept such a risk and will cease to invest in Australian securitisation vehicles or will demand greater returns to offset it.

Further, Australian securitisation vehicles would need to test whether payments on notes held by 25% related parties (or under structured arrangements) are taxable in the recipient's jurisdiction in order to preserve the tax neutrality of the vehicle. This testing would need to be undertaken before each payment is made.

This would impose a burden on a wide number of vehicles, as it is common for notes in a securitisation vehicle to be held by a related party of the sponsor. We note that EU and US risk retention rules require holding of notes in securitisations by the originator or a related party. Although in many cases such notes would be held within Australia, the application of the rules would introduce a further constraint on the ability of the sponsor to deal with their interests in the vehicle.

In addition, because the hybrid financial instrument rule applies to 25% related parties, including situations where a common party holds a 25% interest in both parties, it would become necessary to test whether noteholders in a securitisation vehicle had such a relationship to the sponsor. This would introduce an additional burden, since "associate" testing under the current law usually only applies to entities under common control (i.e. >50%). Sponsors to securitisation vehicles generally do not have protocols in place for identifying 25% indirect interests in themselves, let alone 25% indirect interests in investors to their vehicles.

These additional burdens can be expected to increase the cost of establishing securitisation transactions in Australia vis-à-vis other markets, which would in turn increase the cost of attracting capital to Australian assets.

The United Kingdom

We note that the United Kingdom has implemented the exemptions proposed in OECD recommendation 1.5.

This was achieved via the introduction of specific exemptions in its hybrid mismatch rules for financial traders dealing in stock lending and repurchase transactions, and widely held vehicles such as offshore funds or authorised investment funds including unit trusts and open-ended investment companies

However, the United Kingdom did not need to introduce a specific exemption for securitisation vehicles in its hybrid mismatch rules (found in Part 6A of the *Taxation (International and Other Provisions) Act 2010* (UK)). This is because securitisation vehicles do not rely on deductions in order to achieve tax neutrality in the United Kingdom. Instead, securitisation vehicles are taxed only on their retained cash (under the *Taxation of Securitisation Companies Regulations 2006* (UK)).

Unlike in Australia, hybrid mismatch rules are of little relevance to securitisation vehicles in the United Kingdom, hence there being no need to adopt a specific exclusion.

Request for action

The ASF requests that the exemption for securitisation vehicles detailed in Recommendation 1.5 of the OECD Report and Recommendation 9 of the Board of Taxation report be inserted into the Government's proposed hybrid mismatch rules.

We believe that the drafting required to accomplish an exemption is quite simple. In particular, an exclusion could be inserted for "*any payments made by an entity to which section 820-39 of the ITAA 1997 applies or that is a securitisation vehicle as defined in section 995-1(1) of the ITAA 1997, in either case ignoring the operation of section 701-1(1)) (the single entity rule).*"

Thank you for considering our request. Please do not hesitate to contact us if further information about the interaction between the proposed hybrid mismatch rules and Australian securitisation transactions would be of assistance.

Yours sincerely

[redacted]

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APPENDIX

OECD Report: Recommendation 1.5

The primary response in Recommendation 1.1(a) should not apply to a payment by an investment vehicle that is subject to special regulation and tax treatment under the laws of the establishment jurisdiction in circumstances where:

a) The tax policy of the establishment jurisdiction is to preserve the deduction for the payment under the financial instrument to ensure that:
   (i) the taxpayer is subject to no or minimal taxation on its investment income; and
   (ii) that holders of financial instruments issued by the taxpayer are subject to tax on that payment as ordinary income on a current basis.

b) The regulatory and tax framework in the establishment jurisdiction has the effect that the financial instruments issued by the investment vehicle will result in all or substantially all of the taxpayer's investment income being paid and distributed to the holders of those financial instruments within a reasonable period of time after that income was derived or received by the taxpayer.

c) The tax policy of the establishment jurisdiction is that the full amount of the payment is:
   (i) included in the ordinary income of any person that is a payee in the establishment jurisdiction; and
   (ii) not excluded from the ordinary income of any person that is a payee under the laws of the payee jurisdiction under a treaty between the establishment jurisdiction and the payee jurisdiction.

d) the payment is not made under a structured arrangement.

OECD Report Paragraph 102

Application of the exception to securitisation vehicles and other investment funds

In certain cases, the tax neutrality of an investment vehicle depends not on the particular tax status of the vehicle but on assumptions as to the tax treatment of the instruments issued by the vehicle. One example of this is a securitisation vehicle or an infrastructure investment fund that is financed almost entirely by way of borrowing and where all, or substantially all, of the income is paid out to lenders in the form of deductible interest. The exception to the hybrid financial instrument rule set out in Recommendation 1.5 is intended to protect the tax neutrality of these vehicles while ensuring that they cannot be used to defer or avoid tax at the level of the payee.

Accordingly, the exception applies where the regulatory and tax framework in the establishment jurisdiction has the effect that the financial instruments issued by the investment vehicle will result in all or substantially all of the income of the vehicle being paid and distributed to holders within a reasonable period of time and where the tax policy of the establishment jurisdiction is that such payments will be subject to tax in the hands of investors. Recommendation 1.5 specifically notes that the defensive rule in Recommendation 1.1(b) should continue to apply to such payments on receipt.

Board of Taxation Report Recommendation 9

OTHER EXCEPTIONS

Background

3.75 The Action 2 Report considered that securitisation vehicles and certain investment vehicles[18] should be carved out from the hybrid financial instrument rule to protect the tax neutrality of these vehicles.[19]

3.76 The UK in its draft hybrid mismatch legislation has proposed to exclude:

- financial traders dealing in stock lending and repo transactions; and
- widely held vehicles such as offshore funds or authorised investment funds including unit trusts and open-ended investment companies.

Board's consideration

3.77 The Board's recommendation is set out below.

Recommendation 9

The Board recommends that further consideration be given during the legislative design process to specific exceptions from the hybrid mismatch rules including, but not limited to:

- the exceptions recommended in the Action 2 Report, consistent with the approach taken under recommendation 1.5 in respect to special investment vehicles, including for securitisation vehicles;
- financial traders — repurchase agreements and securities lending agreements; and
- managed investment trusts (widely held).

18 The OECD paper refers to investment vehicles in a jurisdiction that grants the vehicle the right to deduct dividend payments.

19 OECD recommendation 1.5.