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By email:

Dear

Proposed hybrid mismatch rules: impact on Australian securitisation industry
Further concerns and suggested amendments to exposure draft

We refer to ASF's submission dated 29 March 2018 and to our group conference calls held on 10 April 2018 and on 24 April 2018, discussing the particular issues posed by the proposed foreign hybrid mismatch rules for securitisation vehicles in Australia.

The concern of the ASF and its members is that ordinary securitisation transactions could be adversely affected by the proposed rules.

As indicated in our two conference calls, the Australian financial services sector (particularly non-banks) is heavily reliant on securitised funding. Changes to the taxation of these transactions risk disrupting this market, and as such any changes must be considered carefully.

We would be grateful for a better understanding as to why the proposed foreign hybrid mismatch rules are required for securitisation funding transactions in Australia as the payer jurisdiction, rather than neutralised in the payee jurisdictions.

We understand from our calls that the Australian Taxation Office believes that the draft rules already exclude ordinary securitisation transactions. However, we have received advice from specialist counsel that this is not the case. The application of the draft rules to ordinary securitisations may arise as a result of either:

a) the related persons definition; or

b) the uncertainty around the definition of "structured arrangement" in proposed section 832-210,

each of which would establish the existence of a "*hybrid financial instrument mismatch*" under section 832-200.

We submit that the simplest and most efficient means of reducing the uncertainty around the application of these rules to securitisation vehicles is to include a specific exemption, in accordance with Recommendation 1.5 in the OECD/G20 Base Erosion and Profit Shifting Project report, "*Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2*".

Potential mismatches

The potential for, and consequences of, the draft rules applying to a securitisation vehicle arise in the following manner:

a) securitisation vehicles are funded by various tranches of notes, which are ranked in priority of repayment. That is, the most junior notes will experience losses before the most senior notes. Tranching notes in this manner allows the more senior notes to be rated much more highly (with consequent funding cost benefits) than if all notes were equally ranked;

b) both senior and junior notes are regularly issued in the international capital markets;

c) certain jurisdictions may treat junior notes in a manner commensurate with the taxation treatment of equity interests:

   (i) for example, it is possible that the United States would characterise a junior note issued by the securitisation vehicle as equity. Whilst interest payments on the note are still regarded as assessable income they would only be subject to tax on an 'as and when received' basis. In comparison, Australia would allow a deduction on those notes on an accruals basis. Consequently, potential timing differences may arise for periods exceeding 12 months between allowing deductions and recognising income;

   (ii) it is also possible for junior notes to be treated commensurately with equity instruments in Hong Kong, with interest payments being exempt; and

d) disallowing interest deductions in Australia would result in an unfunded tax liability (after retaining an amount as profit, the income earned by the vehicle is used entirely to pay interest on the notes). The potential for this liability to be satisfied from the securitised assets would be taken into account by the note investors such that they either:

   (i) do not invest into the vehicle; or

   (ii) seek a higher return to compensate for this additional risk.

Structured Arrangements

An arrangement is a "structured arrangement" if it gives rise to a hybrid mismatch, and either:

a) the hybrid mismatch is priced into the terms of the scheme; or

b) it is reasonable to conclude that the hybrid mismatch is a "design feature" of the scheme, determined by reference to the facts and circumstances that exist in connection with the scheme, including its terms.

The means by which a matter might be "priced into the terms", or what constitutes a "design feature", is undefined. This test involves the exercise of considerable judgment by the Commissioner of Taxation and is not a risk which can be covered off with any certainty by a legal opinion for potential investors.

It is difficult to say whether a hybrid mismatch is "priced into" the terms of the instrument, particularly given there may be negotiations as to price between the parties and the issuer cannot be certain what factors were considered by the counterparty. It is not unreasonable to expect that a counterparty would take into account the expected tax treatment of the arrangement in both Australia and its home jurisdiction in determining whether it considers the return from its investment to be acceptable. Similarly, on an objective basis, almost any reasonably expected tax outcome could be said to be a "design feature" of an arrangement.

Related Persons

As noted in the previous submission, it is common for some notes to be held by a related party of the sponsor in order to provide additional credit support to senior investors. The application of the hybrid mismatch rules to the notes held by related parties could result in an unexpected tax liability in the issuer vehicle, depleting the assets available to service debt issued to other investors, and thereby indirectly impacting investors who themselves are not subject to the hybrid mismatch rules (and whose circumstances do not contribute to application of those rules).

Importantly, even if the first loss is borne by the subordinated noteholders, there is still an indirect impact on senior noteholders, since any such loss eats into the buffer that would otherwise be available to protect the senior noteholders against defaults in the portfolio. For example, if a senior noteholder has factored in a certain percentage risk of defaults occurring that deplete all junior noteholders but leave senior noteholders untouched, this risk assessment will be undermined if there is a tax leakage in the vehicle caused by the hybrid mismatch rules which depletes junior noteholders before any default is even considered.

Consequences

This uncertainty will likely result in investors in global capital markets favouring securities issued out of other jurisdictions or demanding higher returns on their investment to offset that risk.

Hybrid mismatches could arise unintentionally at any time due to the operation, amendment or reinterpretation of foreign tax laws, or the transfer of notes to holders in countries which treat notes in a manner different from the country in which prior holders resided. Obviously, this is not something over which an Australian issuer and the investors will have control, or even necessarily any visibility. As mentioned above, certain subordinated interests treated as debt for Australian tax purposes may be treated as equity for US tax purposes, due to differences in

the debt and equity tests between the two countries. Other similar issues may arise in other countries, both under current law and in the future.

If securitisation vehicles are unexpectedly subject to taxation as a result of the existence of a hybrid mismatch there is a risk that they will lose their credit ratings, and new securitisation vehicles may be unable to obtain credit ratings, since the applicable credit rating methodologies require tax neutrality in the vehicle. This would have serious implications for the certainty and credibility of the Australian securitisation market.

Recommendation

In accordance with our original submission, we submit that it would be appropriate to exclude entities fitting the criteria in section 820-39(3), which already provides certainty for securitisation vehicles in relation to the thin capitalisation rules.

Section 820-39 contains a pre-existing, well-understood set of criteria which is relied upon by the vast majority of industry. It was cast in flexible terms to accommodate financial innovation. The explanatory memorandum to the Taxation Laws Amendment Bill (No. 5) 2003 (Cth) states that (at 1.14):

> *The three conditions in subsection 820-39(3) seek to cover a broad and ever-expanding range of securitisation activity and structures. For example, the conditions seek to include a warehousing type entity where securitised assets are temporarily placed pending their transfer to another entity. The conditions also seek to cover a two-tiered securitisation structure where one entity holds the securitised assets and the other entity issues the debt interests*.

It was recognised 15 years ago in 2003 that securitisation structures exist in an increasingly large variety of forms, and that therefore a narrow definition would not be appropriate. That variety is partially driven by the evolving nature of global prudential regulations, to which securitisation structures adapt. The three requirements in section 820-39(3) were intended to allow for more complex forms of securitisations to develop and receive the benefit of the exemption from the thin capitalisation rules.

The section 820-39(3) criteria were enacted precisely because the definition of "*securitisation vehicle*" in section 820-942(2) was too narrow to capture the range of securitisation vehicles currently in the market. For example, section 820-942(2) requires the entity to acquire and hold the assets itself, though securitisation vehicles using synthetic exposures to pools of assets are not uncommon and should not be excluded. Using a narrow definition would reverse decades of successful tax policy in this area and would produce a distortionary effect on the securitisation market.

We note that the ATO raised a concern that including an exemption from the hybrid mismatch rules based on section 820-39 would encourage abuse. In response, we note that:

a) It is the ATO's role to administer the law, and if abusive behaviours are detected, to combat those behaviours through compliance activity. This should not impact how Treasury chooses to set policy – or in this case, whether Treasury chooses to preserve a

policy (of tax neutrality for securitisation vehicles) that was established decades ago – unless there is a "loophole" that prevents the ATO from properly administering the law.

b) There are interpretive means available to the ATO to exclude non-bona fide securitisation transactions from the exception contained in section 820-39. The section only applies where the vehicle is established for the purposes of managing economic risk. A vehicle structured in an artificial manner so as to obtain the exception would not pass this test.

c) The ATO has wide powers under Part IVA (including the Diverted Profits Tax) to combat abusive structures in addition to the interpretive means mentioned above. A vehicle that was contrived to satisfy the requirements of section 820-39 would fall foul of the general anti-avoidance provisions.

d) Not implementing an exemption that is recommended by the OECD and which is consistent with an existing policy aimed at facilitating the securitisation industry would have a deleterious effect on an important industry that is beneficial to the Australian economy, in circumstances where (as noted above) other means already exist to address the ATO's concerns.

e) Exemption from the Australian foreign hybrid rules merely shifts the onus of neutralisation to the payee jurisdiction – it does not necessarily permit mismatches to exist. Given that securitisation is to the mere repackaging of the economic exposure of particular assets (i.e. a securitisation vehicle is not a '*risk-taker*' as such), it is appropriate that the onus for neutralisation lies with the payee jurisdiction. In time, we would expect the adoption of foreign hybrid rules by an increasing number of jurisdictions. The incentive for taxpayers to abuse section 820-39 vehicles arising from an exclusion from the foreign hybrid rules would be negligible.

f) As noted above, a policy decision was made to give draft section 820-39 sufficient flexibility to accommodate future financial innovation. To adopt a narrow exclusion for the purposes of the hybrid mismatch rules will create unnecessary complexity in the administration of that policy. If there are particular activities that would satisfy the requirements of section 820-39 but which Treasury considers should be covered by the foreign hybrid rules, such activities could be specifically covered. However, we submit that there are unlikely to be many such activities, since the justification for an exclusion from the hybrid mismatch rules is precisely because a policy has already been made to ensure that section 820-39 vehicles can achieve tax neutrality.

Based on the above, we submit that the simplest and most rational solution to this issue is to adopt the section 820-39 definition as the basis for an exclusion.

We also note that, although the OECD recommendation does not itself extend to structured arrangements, the recommendation is made in general terms to cover many jurisdictions without regard to the other remedies available to the relevant tax authority. As discussed above, the ATO has extensive powers to combat abusive structures through Part IVA (including the Diverted Profits Tax) and through appropriate interpretation of the exclusion in section 820-

39. No useful purpose is therefore served by limiting the exclusion to non-structured arrangements. If the ATO has concerns that a structure is abusive, it will be able to invoke those other remedies, rather than needing to rely on the structured arrangement definition.

Of course, we would be glad to discuss these issues further with you at your convenience.

Yours sincerely

Chris Dalton

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