Australian Banking Association

21 July 2023

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Dear Committee Members,

Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023

The Australian Banking Association (**ABA**) seeks to expedite our concerns on the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023 (the **Bill**) and Explanatory Memorandum. In this submission we address the proposed amendments to the *Income Tax Assessment Act 1997* (**ITAA 1997**) with the introduction of Subdivision 820-EAA (the **Debt Deduction Creation Rules'** or **'the Additional Changes'**).

We note the introduction of the new thin capitalisation earnings-based tests (**Test Changes**) do not significantly impact ABA members as 'Authorised Deposit-taking Institutions' (**ADIs**) are outside the scope of the new thin capitalisation regime, and as acknowledged in the EM[1]. However, the ABA is extremely concerned with the recently proposed Debt Deduction Creation Rules. These rules will directly impact standard financial transactions undertaken by banks in the normal course of banking activities.

We express our significant concern with the lack of consultation on the Debt Deduction Creation Rules and with the mechanism by which these amendments have been brought before the Senate Economic Legislation Committee. This has meant that the ABA and our members have had inadequate time to undertake a review of the proposal for the first and second order impact on banking activities. This concern is particularly acute because the changes, which are proposed to be made effective as of 1 July 2023, and could impact the economics of preexisting arrangements.

In the very limited time to undertake due diligence of the Debt Deduction Creation Rules, we have considered the impact on banks' wholesale funding programs. Banks rely on wholesale funding to meet the demand for credit in the economy. In this submission we provide two examples of bank funding structures that will be adversely impacted by the Debt Deduction Creation Rules. Based on this initial analysis, we have ascertained that the proposed rules could impact some existing and future funding programs. That is, banks' funding costs will increase, with the potential that some or all of that increase may be factored into the customer offerings.

The ABA strongly recommends that this Bill be amended so that the Debt Deduction Creation Rules are removed by deleting Subdivision 820-EAA from this Bill. At a minimum we urge for an exemption for ADIs from Subdivision 820-EAA. The annexure provides more detail.

We would welcome the opportunity to discuss this submission further. Please contact Mitchell Frater-Baird at should you wish to do so.

Regards,

Emma Penzo
Head of Economic Policy

[1] Paragraph 2.15 of the Explanatory Memorandum.

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Annexure

1. Debt Deduction Creation Rules will lead to higher funding costs

The ABA understands the intent of the **Debt Deduction Creation Rules** is to eliminate the opportunity for corporations to minimise tax payable through transfers or arrangements between associates. However, as drafted, the **Debt Deduction Creation Rules** will also negatively impact banks' ability to obtain wholesale funding at an efficient cost.

The lack of consultation and the short timeline in which this submission has been drafted means that the ABA has not been able to sufficiently review our members' funding structures to assess the impact of the **Debt Deduction Creation Rules**. As wholesale funding is a key source of funds from which banks undertake banking, including lending, activities, we provide two examples of structures that will be impacted by the **Debt Deduction Creation Rules**.

1.1 Examples of adverse effects of the Debt Deduction Rules

Example 1 – Foreign Funding Vehicle

This example is a hypothetical (although realistic) situation of a bank's fund raising in the US market, using a US based SPV.

A basic legal structure entails an Australian bank (**Bank B**), and its US based subsidiary (**Bank B USA Subsidiary**) – see Figure 1.

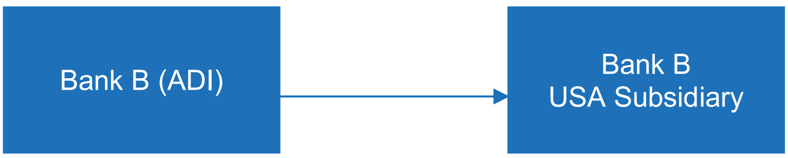

Figure 1

In this example, US investors provide funding to *Bank B USA Subsidiary* (Figure 2 – Financial Transfer #1), which in turn lends the funds to *Bank B* in Australia (Figure 2 – Financial Transfer #2). In raising funds, *Bank B USA Subsidiary* will issue short-dated commercial paper of 6 months maturity. This means the loan is repayable to investors at the end of the 6-month period with interest. *Bank B* in Australia uses the funds to undertake its banking activities, which includes lending to Australian consumers.

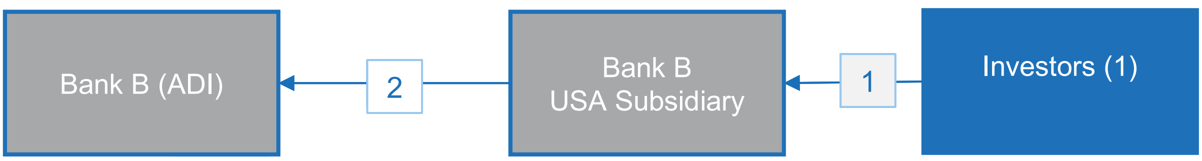

Figure 2

When the commercial paper matures, *Bank B USA Subsidiary* will repay investors (Figure 3 – Financial transfer #4). Concurrently, to maintain funding levels for *Bank B*, *Bank B USA Subsidiary* will make further issuances to the US investor community (Figure 3 – Financial Transfer #3).

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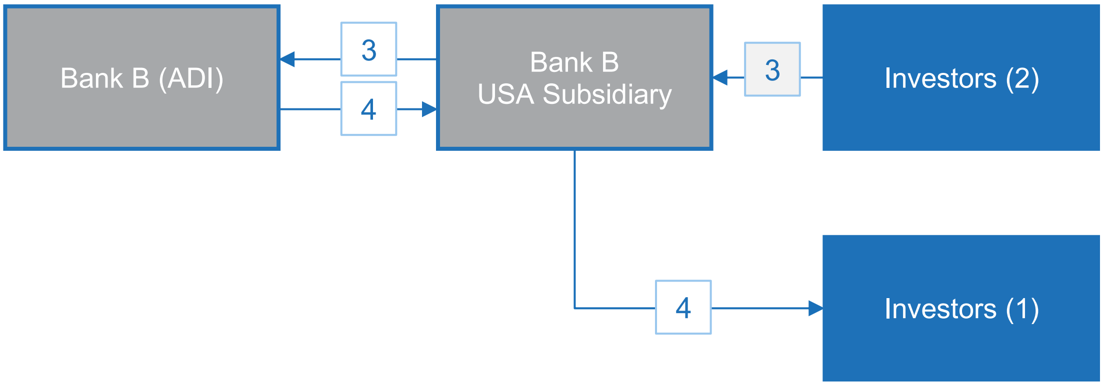

Figure 3

Current tax requirements
Under current thin capitalisation requirements, interest payment by *Bank B* to *Bank B USA Subsidiary* is tax deductible. In the ABA's view this is a justified deduction and represents the costs of funding a bank's operations. The ability to deduct the cost of doing business is a generally accepted taxation principle. The fact that the funding is moved from one entity to another is determined by commercial considerations. That is, it is a valid structure for banks that assists them in competing for international wholesale funds at the most efficient rate.

Draft tax requirements
Under the **Debt Deduction Creation Rules** this transaction will be considered an acquisition between associates. The consequence is that the interest deduction will be disallowed.

The Cost to Banks
We have not had time to adequately assess and quantify the additional costs that will arise from the **Debt Deduction Creation Rules**. The consequence of denying banks the ability to deduct the costs of raising funds for banking activities is potentially significant. Subject to the competitive environment, costs will likely be passed on, in whole or part, to their customers; that is household and business borrowers.

Example 2 – Securitisation Vehicle – Retail Backed Mortgage Securities

Another source of funding for banks is securitisation. This is the process of taking assets off the balance sheet which has the benefit of freeing up banks' capital and funds enabling sustainable credit growth. Securitisation is achieved through the assignment or transfers of assets, often mortgages, into a special purpose vehicle (**SPV**). We note that capital, credit, and securitisation obligations of banks are specified by the Australian Prudential Regulation Supervision Authority (**APRA**) under its prudential architecture which includes standard, guides, and reporting requirements. Securitisation SPVs acquire mortgages and issue securities backed by those mortgages (which securities are referred to as Retail Mortgage-Backed Securities (**RMBS**)). APRA has specific guidelines and regulations that govern the issuance and operation of RMBS. In general, however, a simplified legal structure involves a bank (***Bank A***), whose subsidiary (***Bank A Subsidiary***) acts as the trustee or the equity owner of the *RMBS SPV* (Figure 4).

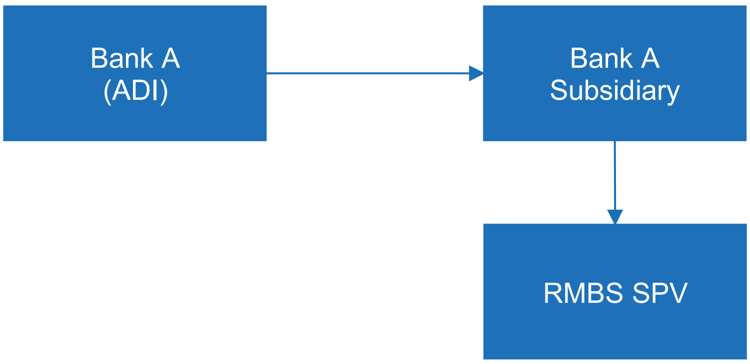

Figure 4. RMBS SPV LEGAL STRUCTURE

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To establish the *RMBS SPV*, an asset transfer is undertaken. *Bank A* will transfer the selected tranche of mortgages to the *RMBS SPV* and will accept a payable of the equivalent value from the *RMBS SPV* (Figure 5 – Financial transfer #5). The *RMBS SPV* will raise funds from investors via RMBS notes and repay *Bank A* for the mortgages. (Figure 5 – Financial transfer #6).

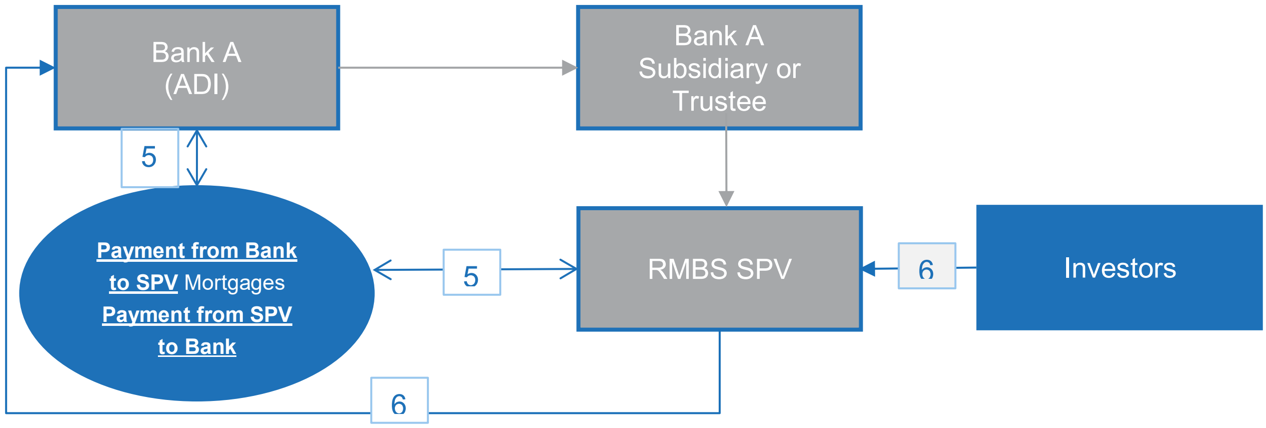

Figure 5. INITIAL SET UP OF RMBS SPV

The maturity of an RMBS note issued to investors will typically range from 5 to 10 years. Over this period, mortgagors make their principal and interest repayments which are transferred to the *RMBS SPV*, in turn the *RMBS SPV* repays investors (Figure 6 – Financial transfer #7).

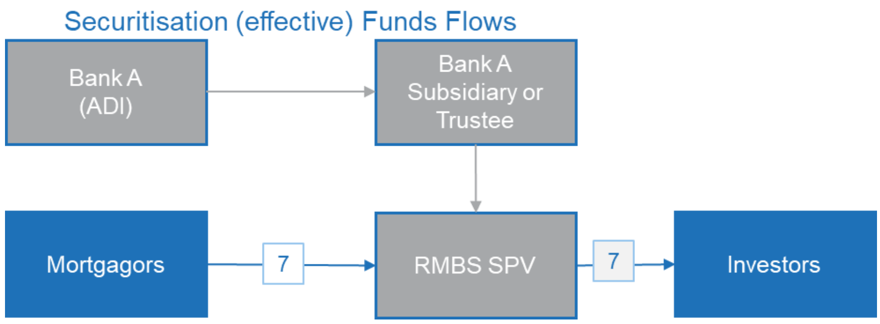

Figure 6. FINANCIAL FLOWS

Current tax requirements

Under current tax rules, the *RMBS SPV* can deduct the interest expense payable to the investors. This aligns with the current practice of paying tax on a net income basis once the costs of business have been accounted for.

Draft tax requirements

Under **Debt Deduction Creation Rules,** the *RMBS SPV* will no longer be able to deduct the interest expense payable to the investors on the *RMBS SPV* notes. This means that the gross income (i.e., the value of the mortgage repayments) of the *RMBS SPV* will be taxable making these legitimate structures more expensive options for banks.

The Cost to Banks

In respect to RMBS issuances, the **Debt Deduction Creation Rules** would potentially make RMBS a less attractive form of funding due to its tax treatment. Increased funding costs to this sector will potentially diminish competition in the mortgage market, making the marketplace less dynamic.

1.2 ABA summary views on Debt Deduction Creation Rules.

Costs to industry

In the ABA's view **Debt Deduction Creation Rules** have not considered the significant adverse impact they will have on banks' fund-raising programs. Competitive and efficient avenues to raise debt capital are essential for banks providing cost effective services to customers. The **Debt Deduction Creation Rules** limit some of the debt-funding options for banks. The impact on the banks' funding programs appears to be an unintended consequence of the proposed debt creation rules, having regard to the stated purpose of the proposed measures.

These changes will likely result in higher funding costs for banks; do not adhere to basic tax accounting principles where taxable income is assessed net of operating expenses.

To manage funding efficiently, banks may need to consider passing on some or all of the costs to their customers. We note the ABA has not had the time to undertake a detailed review of the potential costs of this change and the likely impact to customers.

Drafting concerns

In the ABA's view this 'rushed' drafting of the **Debt Deduction Creation Rules** has resulted in improper interaction with the broader Bill or the ITAA 1997. The Explanatory Memorandum states that Subdivision 820-EAA represents a modernised version of the **Debt Deduction Creation Rules** from the former (repealed) *Division 16G* of the *ITAA 1936*. The Explanatory Memorandum states that Subdivision 820-EAA represents a modernised version of the debt creation rules from the former (repealed) *Division 16G* of the *ITAA 1936*. These former rules had a number of exemptions, such as s159GZZF that allowed for certain necessary transactions. In the ABA's view, the comparative breadth of the **Debt Deduction Creation Rules** in this Bill, with no comparable exemptions to *Division 16G,* demonstrates a failure to properly consider the impact of these changes.

In the ABA's view, the comparative breadth of the **Debt Deduction Creation Rules** in this Bill, with no comparable exemptions to those contained in the former *Division 16G,* demonstrates and incomplete consideration the impact of these changes.

2. Amendments to the Bill

The ABA strongly recommends that **Debt Deduction Creation Rules** as drafted not be passed into legislation. We provide two proposed amendments to this Bill (in order of preference).

1. Remove the **Debt Deduction Creation Rules** from this Bill by removing Subdivision 820-EAA from this Bill.

2. Exemption for ADIs from the proposed Div 820-EAA by removing s820-423A(1)(a)(iv) and s820-423A(1)(a)(v).

3. Inadequate timeline and consultation

It is disappointing that a change of such significance and magnitude has been made with such swiftness and without broad consultation.

In the ABA's view the introduction of the **Debt Deduction Creation Rules** is of a similar, if not greater, magnitude to the previously proposed repeal of s25-90 *ITAA 1997*. The Government's decision pertaining to the deferral of s25-90 is addressed in the EM,

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> *"Stakeholder concerns regarding section 25-90 were considered by Government, with the proposed amendment deferred, reflected in its removal from the final legislation, to be considered via a separate process to this interest limitation measure. Targeted debt creation rules were progressed in its place.[2]"*

Given the deferral of s25-90, the proposed introduction of the **Debt Deduction Creation Rules,** without notice and consultation, is unaligned to the commentary of the EM.

A change of this nature and magnitude requires extensive consultation. After such consultation, if the Government were of a mind to proceed the change, extensive implementation timeframes will be required given the number of existing structures that would be caught by the change, rendering them unsustainable.

About the ABA

The Australian Banking Association advocates for a strong, competitive and innovative banking industry that delivers excellent and equitable outcomes for customers. We promote and encourage policies that improve banking services for all Australians, through advocacy, research, policy expertise and thought leadership.

[2] Page 92 of the Explanatory Memorandum.