



Banking on Tax

Focusing on the core issues

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1 Hybrid mismatch proposed amendment for distributions on AT1 capital

Amendments to the franking offset rules are proposed for distributions on AT1 interests that give rise to a foreign income tax deduction.

1.1 Proposed amendments to the hybrid mismatch rules

Amendments to Australia's hybrid mismatch rules foreshadowed in the 2019-2020 Budget were released as Exposure Draft legislation on 13 December 2019. The amendments cover a range of technical amendments mainly affecting inbound investors whose structures include transparent and hybrid entities and those that provide group finance via lowly taxed entities.

In summary, the amendments:

- Clarify that the rules apply to multiple entry consolidated groups (MEC groups) in the same way as consolidated groups
- Clarify that the definition of 'foreign income tax' does not include foreign municipal or State taxes
- Clarify how the rules apply in the context of trusts and partnerships
- Remove the ordering rule for the targeted integrity rule in cases where there has been a double deduction mismatch and limits the adjustment provisions in certain circumstance
- Clarify the dual inclusion income on-payment rule so that it can be applied to consecutive payments in a group

Details of the above proposed amendments are set out in our Tax Insight available [here](#).

In addition, the Exposure Draft includes a proposed amendment to allow franking benefits on distributions made on Additional Tier 1 (AT1) capital instruments in certain circumstances.

1.2 Regulatory capital franking offset amendment

The hybrid mismatch rules made changes to the franking rules in section 207-158 of the *Income Tax Assessment Act 1997* (ITAA 1997). Section 207-158 operates to deny imputation benefits for shareholders (i.e. franking credit gross-up and offset) on distributions made on/after 1 January 2019 on certain AT1 instruments where all or part of the distribution gives rise to a foreign income tax deduction. These arrangements typically affect non-share equity interests issued by ADIs and insurance companies as AT1 capital where the interest is attributable to a foreign branch.

This rule can apply to deny the franking credit benefits for shareholders where all or part of the distribution is attributed to a foreign branch and may be deductible in that foreign jurisdiction. In particular, the franking credit benefits can be denied on the whole distribution where only a comparatively small amount of the distribution gives rise to a foreign income tax deduction. The Explanatory Memorandum to the Exposure Draft recognises that this could have a significant impact on the pricing of AT1 capital instruments in Australia.

To address this consequence, the Exposure Draft legislation provides an exception to the denial of imputation benefits for distributions on non-share equity interests if both of the following are satisfied:

- The interest forms part of the AT1 capital of an ADI, general insurance company or life insurance company for the purpose of the prudential standards
- The ADI, general insurance company or life insurance company notifies the Commissioner of Taxation that a foreign income deduction will not be claimed for the distribution on the interest.

The notification will be irrevocable and must be made in the approved form on or before the day the distribution statement is required to be given for the first frankable distribution made on the interest or a later day allowed by the Commissioner.

There are also transitional provisions for non-share equity interests already on issue.

Banks that have issued, or intend to issue, AT1 instruments attributable to a foreign branch should monitor progress of the Exposure Draft and, if legislation is passed as currently proposed, prepare to put in place procedures to make the required notification to the Australian Taxation Office (ATO).

This exception will apply for distributions on AT1 capital interests if the ADI, general insurance company or life insurance company notifies the Commissioner of Taxation that a foreign income deduction will not be claimed for the distribution on the interest.

2 Justified Trust and GST – are you ready?

Processes, systems and controls are ‘front and centre’ for the ATO under its GST assurance review programs.

2.1 Current program snapshot

Under its Justified Trust framework, the ATO has moved to an evidence-based assurance program designed to “maintain community confidence that taxpayers are paying the right amount of tax”. The ATO has acknowledged publicly that they are looking for a greater level of assurance that taxpayers are appropriately complying with their tax obligations. The ATO GST assurance programs have a specific focus on the Top 100 and Top 1,000 taxpayers. The programs will see the ATO review, challenge and validate a taxpayer’s GST compliance based on evidence.

The ATO is endeavouring to conduct 100 GST Streamlined Assurance Reviews (SARs) each year over the next four years, with 20 from the Top 100 and 80 from the Top 1,000. Prior to December 2019, approximately 30 Top 100 and Top 1,000 SARs had been completed. This included taxpayers in the financial services industry. Activity is set to ramp up with the ATO investing more resource across its GST assurance programs.

The income tax Justified Trust (Top 100) and Tax Performance (Top 1,000) programs focus principally on tax governance, tax risk and tax treatments adopted. GST systems, processes and controls are the central focus under the GST assurance programs. It is not surprising then that taxpayers that have had an income tax review may find themselves ‘first in line’ for a GST SAR and we are seeing this play out in practice with those taxpayers already selected for review. We expect that the ATO will leverage findings from its income tax reviews – whether that be areas for which assurance was given or areas identified as presenting critical tax risk issues for the taxpayer.

2.2 What is the process?

In short, the ATO is seeking objective evidence to validate that the right amount of GST has been paid. Unsurprisingly, GST processes, systems and controls are ‘front and centre’ of the assurance programs. The ATO has indicated that GST SARs for taxpayers in the Top 100 are expected to be a 12-month review, whereas taxpayers in the Top 1,000 should expect a six-month review. We understand for the GST SAR program that the ATO intend to focus on periods of review that align as much as possible with the financial year.

The GST SAR typically involves at least three requests for information (RFIs) with indicative timeframes of 28 days for responding to each. In addition, the ATO will perform walkthroughs of the Business Activity Statement (BAS), accounts receivable and accounts payable processes. In our experience, the key elements of the ATO’s GST SAR are:

1. Gap analysis – assessing GST governance, processes and controls against the ATO’s ‘Tax Risk Management and Governance Review Guide’ to identify any gaps
2. GST control testing – providing evidence that GST controls have been designed and are operating effectively
3. Process mapping and documentation – providing evidence that systems and processes for GST are sufficiently documented and effective controls are identified
4. Comparison of accounting and GST figures – reconciling differences where accounting and GST figures may not align, performing trend analysis and undertaking exception testing activity
5. Data analytics – testing 100% of transactional data across a 3-month period to identify potential exposures and weaknesses in GST controls

6. GST treatment of significant and new transactions – explaining the GST treatment of any significant and new transactions with effective controls in place to ensure that the appropriate GST classification is adopted. This includes addressing material GST positions adopted by the taxpayer in relation to Practical Compliance Guidelines and Taxpayer Alerts issued by the ATO.

2.3 Initial insights

Based on the GST SARs conducted to date, the ATO has reported that it is seeing an increase in taxpayers engaging external advisors to assist in self-assessing the design effectiveness of their GST control framework. This is important as a key part of any GST SAR will be evidencing both (a) the existence of GST controls, and (b) testing and validating the effectiveness of GST controls.

Initial results shared by the ATO for the reviews already completed are that Stage 1 (tax control framework exists) is the most common rating achieved for tax governance. This means that many taxpayers reviewed to date were unable to produce evidence to satisfy the ATO that their GST control framework is designed effectively (Stage 2) or operating effectively (Stage 3). Further, most taxpayers were rated “medium” for the overall level of assurance. This means that the ATO obtained assurance in only some areas reviewed.

A number of ‘critical risk’ areas have been highlighted based on the initial GST SARs undertaken. Particularly relevant to the financial services industry, reduced input tax credits (RITCs) and GST apportionment continues to be flagged as a ‘GST critical risk’ and will be a focus area for the GST SARs. With GST systems and processes at the forefront of the review, it will be important to ensure that effective controls are in place which allow for the complete and accurate calculation of input tax credits (including RITCs) and those controls have been tested. Having effective GST controls for the processing of transactional data in systems to arrive at a correct apportionment calculation and any determination of RITCs will be key. Other ‘critical risk’ areas flagged include a lack of governance and controls, misapplication of the law and GST classification errors.

However, incorrect BAS reporting was the main GST risk identified from these reviews. Incorrect reporting can often be inadvertent as a result of weaknesses in system controls and inability to quickly identify miscoding and incorrect application of GST. Other key risks observed by the ATO at these early stages of the program include deficiencies in the GST reporting review and approval processes, gaps in the IT control framework for GST, data integrity issues, as well as certain GST technical risks (e.g. apportionment), as highlighted above.

2.4 How to prepare?

The ATO has published fairly substantial information on what is expected from taxpayers to obtain assurance when it comes to GST governance, processes and controls, including broadening of the tax risk management and governance review guide to cover GST. Under the Justified Trust framework, taxpayers are expected to have reviewed the sufficiency of their GST risk and governance processes against the guide and have applied the self-assessment procedures for GST controls testing. Accordingly, a key component of any GST SAR will be providing evidence to the ATO of testing of the controls in place.

GST systems, processes and controls are critical. In anticipation of a GST SAR, we recommend that taxpayers take the following actions:

1. Undertake an analysis to identify any gaps in GST governance, systems, processes and controls and assess readiness for a GST SAR
2. Based on the gaps identified, develop a remediation plan
3. Take the necessary steps to address the remediation actions set out in the plan. This could include activities such as GST data testing, process mapping and updates to tax governance materials.

Being proactive and taking these steps now can assist with appropriately managing the ATO review activity under a SAR. This helps taxpayers to minimise exposure to GST risk and effectively manage GST compliance and associated costs.

Particularly relevant to the financial services industry, reduced input tax credits (RITCs) and GST apportionment continues to be flagged as a ‘GST critical risk’ and will be a focus area of the ATO in the context of the GST SARs.

3 Divestment activities – considering goodwill

Goodwill can be difficult to define and track, making it crucial to initially identify and subsequently track the goodwill attributable to a business. This can make a significant difference if a business to which the goodwill is attributable is ultimately realised by sale or some other means.

3.1 Background

The financial services industry is undergoing a rapid technological and regulatory shift, leading to changes in business models and increase in divestment activities. This shift brings with it the need to carefully consider the tax treatment of goodwill.

Difficulties are often encountered in practice for goodwill associated with a business being divested by a tax consolidated group. Goodwill was recognised on formation of the tax consolidated group or acquisition of an entity and allocated a tax cost as part of the consolidation tax cost setting process. However, due to intervening business reorganisation, it can be difficult to identify a divestment of a business involving the same assets that resulted in the recognition of goodwill on consolidation. This leads to the question whether or not the goodwill recognised on consolidation is being disposed of in part and part retained or, in extreme cases, whether or not that goodwill has ceased to exist and has been replaced with new goodwill. In the latter case, recognition of the tax cost allocated to goodwill on consolidation may be completely lost as there is no process to allocate a tax cost to the new, effectively “internally generated” goodwill.

3.2 Goodwill

Goodwill is a concept that is more difficult to define than describe. Its definition can vary depending on whether the term is used in a business, accounting, or legal (including tax) context.

At law, the central concept to the definition of goodwill is the attraction of custom. In *Federal Commissioner of Taxation v Murry* (1998) 39 ATR 129 (Murry's Case), goodwill of a business is defined as “the combination of tangible, intangible and human assets in such a way that customers are drawn to it”. Although goodwill arises from the combination of those assets, it remains a legally distinct and indivisible intangible asset that attaches to the business as a whole.

The majority of the High Court in *Commissioner of State Revenue v Placer Dome Inc [2018] HCA 89* (Placer Dome Case) confirmed and clarified the principles of Murry's Case. However, the majority stated that goodwill does not extend to every positive advantage and whatever adds value. Rather, goodwill at law extends to all sources that add value to a business by attracting customers, including identifiable assets, locations, people, systems, processes, or techniques.

Stephen J in *Geraghty v Minter* (1979) 26 ALR 141 acknowledged that, for a single entity that carries on multiple distinct business activities, goodwill can also attach to a distinct business as a separately identifiable asset. So, it may be possible for that entity to sell a business and the associated goodwill attached with it.

Whilst seemingly a straightforward principle, practical difficulties can arise on two fronts:

1. Can goodwill be separately identified?
2. Has the goodwill remained a separate asset since acquisition or has the business changed over time to the point where the goodwill is no longer the same asset?

3.3 Goodwill as a separate asset

In *Tax Determination TD 2007/27* (TD 2007/27), the Commissioner considers the way in which goodwill might impact the exit allocable cost amount (exit ACA) calculation on a disposal by a tax consolidated group. Importantly, the ATO confirms that the value of any cost base for goodwill that might be included in step one of the exit ACA calculation pursuant to subsection 711-25(2) of the ITAA 1997 is limited to:

1. Goodwill which was allocated cost base for the entry allocable cost amount (entry ACA) calculation under subsection 705-35(3) of the ITAA 1997
2. Goodwill which is separately identified at the time of calculating the entry ACA.

In this way, subsections 705-35(3) and 711-25(2) of the ITAA 1997 are complementary provisions, highlighting the importance of robust valuations of separately identifiable businesses upon formation or acquisition. This will be important if any cost base allocated to the goodwill in the entry ACA is to be taken into account on exit. It is expected that it would be difficult, in many cases, to undertake a retrospective valuation of either an acquired group or assets recognised on formation of a tax consolidated group to confirm the goodwill assets of subgroups or business units.

3.4 Goodwill as a changing asset

In TD 2007/27, the ATO acknowledges that a goodwill asset can be fluid as it “can split from and merge with other goodwill in accordance with changes to the management, organisation and structure of the business to which it is connected”. It is a question of fact and degree whether or not the goodwill of an acquired business has been (a) subsumed into the goodwill of the acquirer’s business, (b) remained separate, or (c) been lost. Similar considerations could arise for goodwill recognised on formation of a tax consolidated group as a result of reorganisations of business activities following consolidation.

On the one hand, a business that is conducted in substantially the same manner may continue to maintain the same goodwill asset. This goodwill might also be transferred if another entity acquires the right or privilege to conduct the relevant business. Whilst sources of the goodwill may change, or the relevance of a particular source in maintaining the goodwill may vary, as long as the business remains the same, so too does the goodwill asset.

On the other hand, the sources of goodwill may change so much that a business cannot be said to be the same. For instance, the integration of a business unit may cause a goodwill asset to coalesce within the larger business. Similarly, it may be difficult to argue that the goodwill asset has maintained its original identity where a business has expanded, diversified its operations or organically grown.

If goodwill does not maintain its original identity, difficult issues can arise on the future sale of an entity or asset from a tax consolidated group.

For either an entity or asset sale, there may be an effective transfer of only some of the business assets that resulted in the original identification of goodwill. In that case, can it be said that part of the original goodwill has been disposed of or is there new goodwill resulting from the combination of fewer than the original business assets to create a new business?

In other cases, there may be an effective transfer of all of the assets that originally resulted in the recognition of goodwill as part of a larger but integrated business. In this case, the question may be whether or not the original goodwill has been replaced with different goodwill from the combination of the original business assets with new and different assets.

With changes in business operations, the goodwill asset transferred may not be the same as the goodwill asset originally acquired.

Accordingly, with changes in business operations, the goodwill asset transferred may not be the same as the goodwill asset originally acquired. This may mean that the original goodwill asset has been lost, destroyed, or remains but is not transferred, and a new goodwill asset has been created in its place. Moreover, the task of evidencing the loss or destruction of the original goodwill asset (with the object of seeking some tax recognition of the tax cost allocated to goodwill originally) would prove to be challenging.

3.5 Things to think about

Given the complexities upon divestment, taxpayers should clearly identify goodwill upon acquisition of a business or entity or on formation of a tax consolidated group. The burden of proving that a goodwill asset is distinct and separate for the purposes of section 711-25(2) of the ITAA 1997 requires thorough analysis and evidentiary support. This is particularly important where an acquired group consists of a number of distinct business units and activities. Taxpayers should monitor how subsequent activities, functions, mergers or restructures impact the identity of the business and, thus, the goodwill asset.

4 Applying a tax lens to customer remediation payments

There are a number of tax issues for both the customer and banks to consider for remediation payments.

4.1 The Royal Commission

The Royal Commission into the Banking, Superannuation and Financial Services Industry concluded over a year ago, and the Government is taking action on all 76 recommendations contained within the Royal Commission's Final Report (RCFR).

Following the publication of the RCFR, the Australian Government and key industry participants have publicly pledged their commitment to raise accountability and governance standards and to rectify existing failures through compensation payments and refunds. It was estimated in August 2018 that the total amount of compensation to be paid would be about \$850 million.

Banks and other financial institutions have historically made payments to customers to compensate for transactional errors and restore them to a position as if the error had not been made. The Royal Commission brought into focus remediation to compensate for inappropriate advice or refund fees charged for services that have not been provided (fees-for-no-service).

With the increased focus on customer remediation, the estimated quantum of remediation payments to be paid, and the need to restore customers' financial positions, it is important that the tax implications for both the customer and the bank are considered.

We understand that the ATO is currently consulting with the Australian Banking Association (ABA), the Financial Services Council (FSC) on a number of scenarios and tax issues for remediation payments for both the recipients and the payers.

4.2 Categories of compensation

Payments made to compensate customers for errors (including fees-for-no-service) may comprise one or more of the following:

- Reimbursement of fees or premiums
- Lost earnings on the account balance
- Loss of value of the portfolio
- Transaction costs
- Interest or refund of overcharged interest
- Time value of money
- Ex gratia payment or other compensation.

The above can have different tax implications for both the recipient and the financial institution making the payment.

4.3 Tax implications for recipients of compensation payments

To date, the focus has been on identifying entitlement to compensation and determining the quantum of the error to be compensated. Tax issues are coming into focus as financial institutions consider the actual amount to be paid to recipients.

However, there is limited guidance on the taxation treatment of compensation payments received by customers. The ATO guidance published to date includes:

- [Compensation Paid to Individuals for Advice from Financial Institutions](#)
- [Deficient financial advice](#) (superannuation funds)
- [Overcharged insurance premiums](#) (superannuation funds)
- [Compensation received by super funds from financial institutions and insurance providers](#) (superannuation funds)
- [Fees where no service provided](#) (superannuation funds).

The guidance provides some direction for individual and superannuation fund recipients.

While the tax treatment of any compensation payment depends on a taxpayer's specific circumstances, the income tax outcome will also depend on the character of the compensation payment. The ATO's advice for individuals is summarised in the following table:

| Nature of payment | Likely income tax treatment of payment | |
|--|---|--|
| Compensation for loss on an investment | The investment has been disposed by the taxpayer | Treated as additional capital proceeds. |
| | The investments are still held by the taxpayer | Reduce the cost base/reduced cost base of the investment by the compensation amount. |
| Refund of adviser fees | A deduction has been claimed for the adviser fees in a previous year | Treated as assessable income in the year the payment is received. |
| | A deduction has not been claimed for the adviser fees | <p>Not assessable income.</p> <p>If the fees were included in the cost base/reduced cost base of any investments, reduce the cost base/reduced cost base by the refund amount.</p> <p>If the relevant investments have been disposed of and any resulting capital gain or loss has been included in a previous income year, the tax return for that year may need to be amended.</p> |
| Interest | The interest component is assessable as ordinary income and should be included in the income year it is received. | |

However, there are a number of other factors which are relevant to consider from a tax perspective, including:

- Whether or not the investment was/is held on revenue account or capital account by the customer?
- Is the tax status of the recipient the same or has there been a change (e.g. resident to non-resident or vice versa)?
- If the amount received is an undissected lumpsum amount, can the amount be allocated and, if so, what is the basis for this allocation?
- If an amount is capital proceeds, what is the relevant CGT event and when did it occur? Is the taxpayer able to apply the CGT discount?
- Does the customer still hold the account? If not, what is the character of the payment being made?

4.4 Tax implications for financial institutions making the payments

Remediation payments to customers also have a tax impact for the financial institutions making the payments. Tax considerations from the payer's perspective include:

- What is the taxation character for the bank of the compensation payment being made (e.g. capital or revenue, gain or loss on a financial arrangement or a portfolio fee)?
- Whether the compensation payments should be made on a pre-tax or post-tax basis and, if made on a post-tax basis, what taxation factors for the recipient should be taken into account?
- Whether any information should be included in customer communication to assist the customer to determine the tax impact of the payment? If so, what information can be included without providing taxation advice? Should the communication set out components of a lump sum?
- Is any part of the payment interest? If so, does withholding tax apply if paid to a recipient that is non-resident or a resident who has not quoted a TFN or ABN?
- Whether there are any reporting obligations for the payments (e.g. Annual Investment Income Report, non-quotation of TFN/ABN reports)?
- What are the GST impacts of the payment?
- If the payment is made to a customer that is an employee of the bank, are there FBT or other employment tax impacts?
- What is the taxation treatment of costs incurred by the financial institution in determining compensation payments to be made?

4.5 Recommended actions

We understand that the ABA and FSC have raised most, if not all, of the above issues with the ATO and provided a number of scenarios for the ATO to consider. Banks should continue to document the different scenarios that arise and the associated tax issues and pro-actively engage in the consultation process with the ATO through the ABA and FSC. Banks should also monitor and review guidance as it is issued by the ATO.

Banks should consider the potential tax impacts of remediation payments, document the different scenarios that arise for the bank, pro-actively engage in the consultation process with the ATO and monitor guidance issued by the ATO.

5 The tax governance outlook for 2020 for the banking sector

In an environment of increased focus on governance, the Top 100 and Top 1,000 reviews concluded so far offer a number of insights and areas of focus for banks in 2020.

5.1 Background

A range of bank governance and compliance issues were well publicised in the media as 2019 drew to a close. While these issues were unrelated to tax, what are the lessons that can be learned from the emergence of these serious governance matters?

The first lesson is that tax is an integral part of the overall risk management landscape in any large organisation. The ATO's focus on tax governance pursuant to the Justified Trust initiative since 2016 has at least afforded large corporates, including banks, the opportunity to "refresh" their tax governance frameworks.

The second lesson is that, from the ATO's perspective, there will be ongoing monitoring of the effectiveness of tax governance frameworks to ensure that Justified Trust is maintained.

Jeremy Hirschhorn, Second Commissioner Client Engagement Group at the ATO, noted in a 2019 address to Deloitte that, while the Top 1,000 Streamlined Assurance Review (SAR) program and the corresponding Top 100 program has had a positive effect on the documentation of tax governance frameworks of corporate groups, there was still a disconnect between the documented frameworks and actual corporate behaviour. That is, there were instances where tax governance policies indicated a conservative approach to tax risk management but, the corporates were still engaging in higher risk tax behaviour.

This is an important insight. Tax policies need to be "lived" in deed, not just documented in word.

In that same address, Mr. Hirschhorn also raised the interesting point that the ATO has approximately the same number of case officers available to 'police' tax compliance in Australia, as the Internal Revenue Service (IRS) in the United States (US). The US economy is approximately fifteen times the size of Australia's. This relativity suggests the likelihood of detection of lax tax compliance and/or high-risk behaviour in Australia is very high.

5.2 Insights from the Top 100 and Top 1,000 program

A number of insights have been gleaned from the ATO's Top 100 and Top 1,000 reviews to date.

5.2.1 Tax governance – Top 100

Since 2012, the ATO approach to assessing the strength of a tax control framework (TCF) for a Top 100 taxpayer has evolved. The Risk Differentiation Framework (RDF) morphed into a more tailored risk categorisation process (through the Justified Trust program) which has now been replaced by Key Taxpayer Engagement (KTE) under the Action Differentiation Framework (ADF) approach, which will commence in 2020.

Pursuant to the ADF, public and multinational businesses will be grouped according to total business income. The Top 100 will be taxpayers with total business income of more than AUD\$5B or, where the taxpayer is considered a "market leader". In conducting the ADF approach, the ATO intends to build on the information obtained from the Justified Trust program, to design a "one-to-one tailored engagement" with each of the Top 100.

As we have seen in recent Top 100 reviews, the ATO now expects each Top 100 taxpayer to have a well-documented and effectively designed (and tested) TCF. The proposed “real time” method used by the ATO to engage with this taxpayer group suggests the ATO will be testing the actual effectiveness of a TCF. For example, the ATO will assess the rigour with which a TCF is applied in practice to an actual transaction (or transactions). This requires tax governance frameworks to be “lived”, not just documented. Accordingly, “significant transaction” escalation controls should be included on upcoming tax control testing plans.

Tax policies need to be “lived” in deed, not just documented in word.

5.2.2 The Top 1,000

The comments above regarding the need for a TCF to reflect actual operating conditions, apply equally to taxpayers in the Top 1,000 subject to an ATO SAR or, more likely over the next 12 months, a SAR follow-up. Based on our experience assisting with responses to SARs or SAR follow-ups (the so-called “Next Actions” stage), the ATO is interrogating the practical application of a client’s documented TCF to a greater degree of detail than over the first two years of the Justified Trust program. This reinforces Jeremy Hirschhorn’s comment noted above regarding the disconnect sometimes observed between what a client’s TCF says should happen and the tax risk management behaviours conducted in practice.

As the ATO initially published its Tax Risk Management and Governance Review Guide (the ATO Guide) in 2017, we understand the ATO believes the corporate sector has had ample time and warnings to implement appropriate tax governance frameworks. These insights point to the focus of the “Next Actions” being to seek assurance that tax control testing is implemented and reported at Board level.

5.2.3 The rise of fintechs

By the end of December 2019, at least three “neobanks” had been granted authorised deposit-taking institution (ADI) status by APRA. Fintechs have unashamedly set out to disrupt the banking sector: they target a younger market (18-35) with more tailored deposit products and are winning small business customers away from the bigger banks through streamlined credit approval processes. Neo-banks are entirely digital, do not have branches and their sales platforms are apps. This model raises a number of governance issues for both the neo-banks and their traditional rivals.

The typical journey for a neo-bank is from tech start-up to an operating bank. This often rapid journey means that TCF principles are not always front of mind in the start-up phase. Available funding is directed to product development and most start-ups incur tax losses during their formative years. As a neo-bank moves into the ADI operating phase, there will likely be a need to wrap governance protocols around its tax activities, as well as its broader finance operations.

For traditional banks, the commercial necessity to compete with the neo-banks will mean entering the digital banking arena. Whether this new activity is executed directly by introducing new business platforms or indirectly through investments in future neo-banks, the banking sector should be mindful of the recent systems-related compliance failures referred to in the introduction that have highlighted possible gaps in governance and compliance frameworks and brought adverse media attention.

Tax governance is now an embedded priority that the banking sector, including large and small participants, can safely assume will be an area of focus by the ATO (and increasingly, global revenue authorities) for the foreseeable future.

6 Revised R&D tax incentive bill now before Parliament

The proposed amendments based on the incremental intensity of R&D expenditure of an entity will significantly change the calculation of tax offsets under the R&D regime.

6.1 Background

The *Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019* was introduced into the House of Representatives on 5 December 2019. This Bill, replacing an earlier lapsed Bill, contains slightly revised measures to enact the long-proposed changes to the calculation of the tax offsets available under the research and development (R&D) tax incentive regime.

Notably, these changes will not impact the eligibility of R&D activities within the banking industry. Rather, the technology driven nature of R&D by banks will be impacted by the current re-examination of the treatment of software and the establishment of the proposed new Digital Economy and Technology Division announced by Karen Andrews last year. This division is intended to work with industry to develop policy in areas including artificial intelligence, blockchain and international standards development.

6.2 Key aspects for banks

For Australian banks and financial institutions, which are likely to only be eligible for the current non-refundable R&D tax offset, the key R&D changes now proposed include:

- A revised commencement date of 1 July 2019
- The continued introduction of controversial intensity threshold premium tier thresholds and rates in calculating the non-refundable offset available.

A bipartisan Senate Committee previously recommended fundamental refinements to any such R&D intensity measure to reflect the inherent differences in R&D intensity across industries and potential negative impacts on businesses with large operating costs, including banks. Disappointingly, the current Bill largely remains identical to the earlier lapsed Bill, with the exception of some minor tweaks to the premium tier offset rates.

The regulatory impact statement acknowledges that 65% of the companies currently claiming the non-refundable R&D tax offset have an intensity rate of less than 4%. As such, if enacted without further change, it is likely the amendments will result in poorer outcomes than envisaged for the majority of banking and financial claimants which generally have lower levels of R&D intensity.

6.3 Revised proposals for the non-refundable R&D tax offset

The proposed measures continue to tie the amount of the non-refundable R&D tax offset to the incremental intensity of R&D expenditure of an entity. Incremental intensity will be calculated as eligible R&D expenditure as a percentage of total expenses, as reported in Item 6 of the company income tax return.

The provisions will, once enacted, completely replace the former concept of a flat rate non-refundable R&D tax offset and commensurate after-tax benefit. Instead, the proposed legislation will allow a 'basic' non-refundable tax offset amount at a rate equal to the entity's prevailing corporate tax rate for the income year.

If enacted without further change, it is likely that the amendments will result in poorer outcomes for the majority of banking and financial institution claimants which generally have lower levels of R&D intensity.

A set of tiered thresholds will allow increasing levels of R&D expenditure to potentially attract up to three marginal 'premium' R&D tax offset amounts in accordance with the following table:

| Overall R&D intensity rate* | R&D tax offset premium amount |
|-----------------------------|---|
| Less than 4% | 4.5% for R&D expenditure between 0%-4% R&D intensity |
| Between 4% and 9% | 4.5% for R&D expenditure between 0%-4% R&D intensity; plus 8.5% for R&D expenditure above 4% to 9% R&D intensity |
| Over 9% | 4.5% for R&D expenditure between 0%-4% R&D intensity; plus 8.5% for R&D expenditure above 4% to 9% R&D intensity; plus 12.5% for R&D expenditure above 9% R&D intensity |

*Calculated under new subsection 355-100(1A) as *Notional R&D deductions/Total expenses*

The sum of the premium rates for each tier will be added to the 'basic' tax offset amount calculated at the entity's prevailing corporate tax rate to arrive at the total R&D tax offset amount.

Notably the R&D intensity definitions are based on the R&D entity itself, with no reference to connected or affiliated entities which are relevant for establishing the aggregated turnover threshold. Within a tax consolidated group, the head company will be the relevant R&D entity under the single entity rule, which could aggravate the potential negative impacts on consolidated groups with large operating costs.

In line with these changes, the maximum R&D expenditure that can attract a premium offset rate will be increased from \$100 million to \$150 million per annum. For large banks incurring eligible expenditure in excess of \$150 million, the R&D offset premium will be nil, attracting only a tax offset at the prevailing corporate tax rate. However, this mechanism will still allow capital software expenditure in excess of \$150 million to be notionally deductible when incurred.

Overall the proposed new regime will create uncertainty for banks in forecasting the level of the incentive available for each income year. Although the intensity mechanism appears to be less blunt than first proposed, it will still unduly discriminate against companies with high levels of general "total expenses", including banks.

6.4 Clawback and catch-up amendments

There are also non-controversial measures that seek to amend the balancing adjustment, feedstock and grant clawback provisions, which all currently claw back a flat rate net tax benefit of 10 per cent.

Once enacted, the revised Bill will remake and consolidate the existing legislation that currently deals with the clawbacks for R&D recoupments and feedstock adjustments. A new subdivision 355-G will introduce a uniform clawback rule that will apply in both scenarios, as well as where any assessable balancing adjustment amount arises. The actual net tax benefits obtained will be clawed back under the proposed measures.

Similarly, the revised Bill will introduce new subdivision 355-H to replace the current provisions dealing with deductible balancing adjustment amounts for an R&D asset. The catch-up rule will mirror the operation of the proposed uniform clawback rule but will operate in reverse, providing a deduction in lieu of an amount of R&D tax offset forgone. Notably the amendments will mean that such balancing adjustment deductions will be real deductions rather than notional, creating only tax losses.

6.5 Other proposed R&D changes

If enacted, the following key changes in the Bill will also affect banking and financial claimants:

- Part IVA will be amended to explicitly extend the concept of tax benefits to include the refundable and the non-refundable R&D tax offsets. The amendments to Part IVA will apply with effect from Royal Assent to tax benefits obtained in connection with a scheme, whether or not the scheme was entered into, or was commenced to be carried out, before that day.
- The Commissioner of Taxation will publish the name and ABN of entities that lodge an R&D schedule with the company income tax return, together with the amount representing the R&D entity's notional deductions, taking into account any feedstock adjustments. Publication of this information will be delayed for two years in the interests of protecting commercially sensitive information. Disappointingly, notional deduction amounts will be reported rather than the net tax benefit of the claim, which could lead to further public misunderstanding of the corporate tax gap.
- No extensions of time beyond three months can be granted, unless the extension is granted to allow an applicant to wait for the outcome of a pending decision.



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