Parliamentary Joint Committee on Corporations and Financial Services

ANSWERS TO QUESTIONS ON NOTICE

Australian Taxation Office

Inquiry into impairment of customer loans

4 April 2016

Department/Agency: ATO
Question: 1
Topic: Penalty interest and assessable income of banks
Reference: Hansard – page 2

Question:

CHAIR: Sure, so the simplest case is where a debt is provisioned for and then becomes a bad debt and then you have an actual dollar amount. There is also a transitional state, if you like, where a loan is impaired. The banks tell us that they have a higher cost of providing finance in that environment. I would be interested to know whether the rules you have mentioned cover how they can treat that higher cost of providing the finance from a tax perspective. Also they then charge consumers default or penalty interest rates—there are various words they use for it. I would be interested to know whether the rules specifically cover how that additional finance, that income flow coming to the bank, is treated from a tax perspective.
Ms Carey: Certainly penalty interest, default interest or fees that the banks may charge would form part of their assessable income under normal income provisions. There is no issue around that. The issue I suppose is if in fact those payments themselves remain unpaid. Again the same rules would apply to doubtful debts more generally because the income should be returned by the bank or the financial institution if income is not received or the income is recognised because the taxpayer is on an accruals basis but in fact the payment is never received. Then again there would be a deduction that the bank or financial institution could claim under the previous provisions that I referred to.
CHAIR: So from a tax office perspective penalty interest rates are essentially additional profit for the bank?
Ms Carey: Yes, that is correct.
CHAIR: If the rules were to change such that, if somebody were in default and penalties were applied, those funds went to paying down the balance of the loan as opposed to going to the profit sheet of the bank, how would that be treated from a taxation perspective?
Ms Carey: If it is not regarded as part of the assessable income of the bank?
CHAIR: Yes.
Ms Carey: I would need to take that on notice.

Answer:

For banks, interest and penalty interest amounts are assessable as they accrue (this is independent of payment). Repayments of principal are not taxable (unless they are recoveries on debts previously written off as bad).

Accordingly, under current tax rules, it is usually not relevant for the bank's tax purposes whether repayments are contractually treated as repayments of interest, penalty interest or principal.

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Inquiry into impairment of customer loans

4 April 2016

Department/Agency: ATO
Question: 2
Topic: Sale of property and GST
Reference: Hansard – pages 3

Question:

CHAIR: At least one submission has raised the issue of property that has been sold by a liquidator and subsequently the bank has come back some months after the transaction and demanded a payment—in one case around $36,000—for GST on that sale. The submission made it very clear that in the original paperwork the sale was not subject to the goods and services tax, according to the paperwork and the boxes that were marked. From the tax office's perspective could you give us an opinion? Would it be your expectation that the sale of any property, regardless of whether it was at the hands of a receiver or from normal processes, would be subject to GST and who would be liable to pay that?
Ms Carey: You have me at a slight disadvantage because I am not a GST expert. I am happy to take that particular issue on notice and check with our goods and services tax area. My understanding is that in most cases GST would apply, but there could be particular circumstances and particular rules that would apply in a particular case. Obviously in that case I am not aware of the background facts, but I am happy to take that on notice and take that issue up with my GST colleagues.

Answer:

Not all sales are subject to GST. GST is only payable if the supply is classified as a taxable supply (e.g. commercial premises, vacant land, etc.). GST is not payable if the supply of property is input taxed (e.g. 'old' residential premises) or GST-free (e.g. farmland).

In normal circumstances, the GST liability on a taxable supply of property would be the responsibility of the entity making the supply if that entity is registered, or required to be registered, for GST.

However, the *A New Tax System (Goods and Services Tax) Act 1999* has special rules for incapacitated entities where a representative such as a liquidator has been appointed (Division 58) or where property is sold by a creditor in satisfaction of a debt (Division 105).

The submission mentioned above, where a bank sought around $36,000 in GST some months after the sale settled, appears to relate to a sale of the property owner's (debtor's) commercial property by the bank (creditor) as mortgagee-in-possession.

Where a sale relates to a supply of commercial property it would usually be treated as a taxable supply, unless the debtor has provided reasons in writing as to why the supply is not taxable. Under the provisions of Division 105, the bank is liable to remit the GST on the sale, reducing the balance of the sale's proceeds available to offset against any remaining debt.

Without examining the executed sale contract, and the particular circumstances of the transaction mentioned in the submission, it is not possible to offer an opinion as to why the original paperwork indicated that GST was not applicable to the sale or why there was a delay in the bank notifying of the GST liability.

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4 April 2016

Department/Agency: ATO
Question: 3
Topic: Banks complying with AASB 139
Reference: Hansard – page 3

Question:

Senator KETTER: Ms Carey, you mentioned that it is TR 92/18 that provides us with guidance as to what is considered a bad debt. Is that the current position of the ATO?
Ms Carey: Yes. Even though it is quite an old ruling the principles still apply to the current legislation.
Senator KETTER: Just looking at that, and with regard to the terms of reference that we have, it says:
A debt may be considered to have become bad in any of the following circumstances—
a number of which do not seem to be relevant to our current terms of reference. But in paragraph 31(d) it says when:
… the debtor is a company, it is in liquidation or receivership and there are insufficient funds to pay the whole debt …
And then (e) says:
… where, on an objective view of all the facts or on the probabilities existing at the time the debt, or a part of the debt, is alleged to have become bad, there is little or no likelihood of the debt, or the part of the debt, being recovered.
How does that line up with the technical defaults that we are looking at, where there has been no actual monetary default. We are talking about situations where loan-to-value ratios or other breaches of covenants might have occurred that do not really seem to fit there. Can you elaborate on that?
Ms Carey: Certainly. I mentioned division 230, which applies to the taxation of financial arrangements. Under division 230, which, as I said, applies to banks and other financial institutions, taxpayers are actually involved in providing financial arrangements for their customers and clients and there is the ability there to—it is actually described as the 'fair value method'. It is the methodology for the taxpayer to determine the actual amount of the loss. That provision appears to relate to impairments, including doubtful debts. I would call them doubtful debts; you described them as impairments. Essentially, it is comparing the fair value of the financial arrangements decreasing from one income year to another. That would be one methodology where a taxpayer, even though the debt was not bad, by essentially revaluing the loan a deduction will be triggered. But there are certain requirements that would have to be complied with. The taxpayer has to elect to adopt that methodology, and it also has to reflect what is included in the accounts of the taxpayer. Again, I am not an accounting expert, but accounting standard AASB 139 basically sets out the conditions under which that revaluation can occur, and the tax law then reflects that accounting treatment.
Senator KETTER: If I heard you correctly, you are saying it is really for the taxpayer to determine the amount of the doubtful debt in that situation?
Ms Carey: It is based on the fair value, however that is determined.
Senator KETTER: Does each of the major banks adhere to that standard—I think you said AASB 139.
Ms Carey: Yes.
Senator KETTER: Is that commonly applied by the major banks?
Ms Carey: Again, I would have to take that on notice, but I would certainly hope so. I would assume so.

Answer:

For accounting purposes, most banks use the amortised cost method for accounting for loans and receivables (refer to paragraphs 9 and 46 of AASB Standard AASB 139 – Financial Instruments: Recognition and Measurement), not the fair value method. The accounting rules for impairment of loans and receivables are set out in paragraphs 63 to 65 of AASB 139.

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For tax purposes, most banks have made elections under the "Taxation of Financial Arrangements" provisions (Division 230 of the *Income Tax Assessment Act 1997*) that the taxation treatment aligns with the accounts on these loans and receivables. Deductions for impairments are only available if the debt is written off as bad. This is a higher threshold than accounting impairment.

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Australian Taxation Office

Inquiry into impairment of customer loans

4 April 2016

Department/Agency: ATO
Question: 4
Topic: TR 92/18 and bank compliance
Reference: Hansard – page 4

Question:

CHAIR: How often does the ATO audit the major banks in terms of their compliance?
Ms Carey: How often?
CHAIR: Ever?
Ms Carey: Yes. Obviously I will not go into individual details, but we have ongoing engagement certainly with the big four banks—big five if you include one other. I will not name it. I specifically will not name taxpayers. We certainly have a process of ongoing review of the various transactions that the banks and other financial institutions are involved in.
Senator KETTER: I imagine, post GFC, this would be an area that the ATO would be looking at. I presume there would have been a rise of the level of doubtful debts or bad debts at that time—would that be correct?
Ms Carey: Yes. They rise and fall in a cyclical pattern, but certainly, yes, that would be one issue that we would be looking at as part of our ongoing reviews of the banks, as well as many other aspects—particular transactions they are involved in, particular types of financing. Certainly bad debts generally would fall into the category of the sorts of issues that we would look at as part of a general review of the tax position of the banks.
Mr VAN MANEN: I want to dig down on this a little bit more, because it is a very important issue. I would be interested, even if you take it on notice, for you to be far more forthright with the committee in relation to the actual work the ATO has done in ensuring the banks are complying, during both the GFC period and post-GFC, with these particular provisions in TR 92/18. Because you frequently see, year in year out, the banks regularly review their bad and doubtful debt provisions on their financial statements, and it can have a material effect on their profitability or otherwise. I would be very interested to know in some detail as to what work the ATO is actually doing. I will accept it if you want to take that on notice, but if you have the capacity to comment now, I would be very interested.
Ms Carey: Certainly I do not have the capacity to comment on the details now; I will take that question on notice.

Answer:

The issue of bad debts being claimed by taxpayers in the banking and finance industry has arisen in a number of active compliance interactions in recent years. This issue, along with other issues and risks, has been a focus of active compliance activity since the Global Financial Crisis.

Bad debt deductions have been the focus of taxpayer audits, specific risk reviews and Active Compliance Arrangements with a range of banks, both domestic and international. Taxpayer confidentiality provisions prevent the Commissioner from providing any information in relation to individual cases.

The ATO continues to monitor this issue as part of our overall review of risks in the banking and finance sector more generally.

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Australian Taxation Office

Inquiry into impairment of customer loans

4 April 2016

Department/Agency: ATO
Question: 5
Topic: ATO view of impaired loans
Reference: Hansard – page 4

Question:

Senator KETTER: Just following on from that, the ATO would do some industry level monitoring here to look at—I recognise the stability of the financial systems and another agencies responsibility, but you would have your own areas of concern in this field when it comes to taxpayers paying a fair amount of tax.
Ms Carey: Certainly. Again, and perhaps I should have explained the particular area within public groups and international that I manage, but I do manage the banking and finance strategy area within public groups and international. We actually have a specific strategy team that manages and monitors what is happening in the banking and finance sector. Without providing details in relation to these particular deductions, I can certainly indicate that we are closely monitoring the banking and finance sector. We are certainly very focused on the sorts of transactions that they are involved in. We have a working relationship with the banks as well, so we understand what particular issues they are focusing on or are of particular interest to them at a particular period in time. The period during the global financial crisis, even though I was not actually in this role at that time, certainly we were conscious and aware of issues like the level of bad debts that the banks were experiencing at that time.
Senator KETTER: So having said that you monitor that and you analyse what is going on, does the ATO have a view about some of the very high profile cases that have been in the media about the impairment of loans—perhaps the technical ways in which those loans were impaired? Have you formed a view about that from a tax point of view?
Ms Carey: I would have to take that on notice.
Senator KETTER: I would be a bit surprised that you do not have a view that you could share with us today. This is something that has exercised a lot of the print media, and it is certainly a matter of keen public interest. I would be surprised if you were not able to tell us something about the ATO's view on this issue.
Ms Carey: Certainly we would be looking at that in the context of the audit and active compliance work we are doing in relation to the banks. Whether we have reached a view on the extent to which the banks are complying with the existing law or not, our role is to ensure that they are complying with the existing law.
Mr VAN MANEN: To reiterate the chair's opening comments, it is somewhat of a disappointment that the ATO does not seem to be more across this issue, given the level of publicity and interest it has generated over a significant period of time. I would be interested to know, more particularly, if the banks do write off a loan and claim that as a loss and the bank is, subsequently, able to recover some level of funds—whether it be through payments from guarantors or mortgage insurers or claims against other third parties—how are those proceeds treated? Are they treated as a capital repayment or are they treated as income for tax purposes? If a bank writes off a significant amount of a loan it reduces their tax payable. I would be interested in knowing how the ATO treats any recoupment of those losses.
Ms Carey: The recoupment itself would be treated as assessable income of the bank.
Mr VAN MANEN: This goes back to my earlier question. How much work is done by the ATO to ensure that this is properly accounted for?
Ms Carey: Again, that would be looked at as part of a review of a particular bank. It is one of many issues that we would look at as part of any active compliance activity, in relation to a bank or financial institution, ensuring that the banks were complying with the income tax law provisions and how we have explained those provisions should operate through our various public rulings.
Mr RUDDOCK: Is 'review' the same as 'audit'? You keep using the word 'review'. I am anxious to know whether banks are, effectively, audited, in relation to the full range of matters that we are raising.

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Ms Carey: We have a range of products, from audits to specific issue reviews to ongoing active compliance activities. The banks are subject to a range of those.
Mr VAN MANEN: In light of that response and back to my earlier question, what level of work—that you are aware of in your current role—is being done by the ATO with the banks to ensure that the tax obligations are being met, in relation to these impaired loans?
Ms Carey: I would need to check with our active compliance teams to see to what extent they are focusing on this as a particular issue. This is one of many issues we are focused on, in relation to the banks. It is a significant one, from the point of view of the committee, but it is one of many issues that we would be looking at, in relation to both the big four banks and the other banks.
Mr VAN MANEN: Wouldn't you be looking at the banking industry as a whole rather than just the big four banks?
Ms Carey: Yes, we would be.

Answer:

Taxpayer confidentiality provisions prevent the Commissioner from providing any information regarding the identity of taxpayers involved in and the outcomes of any active compliance activities.

A range of active compliance activities have been undertaken since the Global Financial Crisis, focusing on deductions claimed for bad and doubtful debts by banks and financial institutions. These have involved both international and domestic banks claiming deductions for bad debts and loan impairments.

Active compliance activities have ranged from Audits, Client Risk Reviews, Active Compliance Arrangements and Pre Lodgement Reviews of taxpayers within the banking and finance industry. These active compliance activities also covered other potential issues of concern to the ATO and did not solely focus on bad and doubtful debts or the treatment of impaired loans.

Parliamentary Joint Committee on Corporations and Financial Services

ANSWERS TO QUESTIONS ON NOTICE

Australian Taxation Office

Inquiry into impairment of customer loans

4 April 2016

Department/Agency: ATO
Question: 6
Topic: ATO engagement with AFP, APRA, ASIC and other agencies
Reference: Hansard – page 6

Question:

Senator O'NEILL: What are your interactions with the Australian Federal Police and APRA with regard to fit and proper persons, cultural practices and questions of uncertainty about whether banks are behaving in ways that would be exemplary in terms of corporate products?
CHAIR: We can include ASIC in that list of agencies as well.
Ms Carey: Certainly, my area does have interactions with APRA; not so much ASIC and the federal police but the ATO as a whole does. I would need to take on notice the extent to which those interactions related specifically to the banks.
Senator O'NEILL: I will have one more detailed question on notice.
CHAIR: As part of that question on notice—noting that the head of ASIC is making a significant pitch around culture and likewise the ATO, APRA and even to a certain extent other agencies such as ACCC are talking about culture, it strikes me that a whole-of-government approach would be appropriate as opposed to having multiple strands—if you could come back with a detailed answer about your engagement with the other agencies.

Answer:

There is ongoing interaction between the ATO and other government agencies, including the Australian Federal Police, the Australian Prudential Regulation Authority and the Australian Securities and Investment Commission. These interactions cover a range of issues, some dealing with individual taxpayer matters, while others relate to common risks for the relevant agencies and the development of common and joint strategies to deal with these risks.

Given the publicised focus of these agencies on the culture of and behaviours of businesses and individuals, it is anticipated that the ATO will continue to engage jointly with other government agencies to influence positive culture and behaviours.

The work already undertaken by the ATO on its “Tax Risk Management and Governance Review Guide”, developed in collaboration with taxpayers and advisers (including some of the major banks), is an example of the work that is being undertaken within the ATO to influence the culture within publicly listed taxpayers. This should feed into some of the wider conversations with the other listed agencies.

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ANSWERS TO QUESTIONS ON NOTICE

Australian Taxation Office

Inquiry into impairment of customer loans

4 April 2016

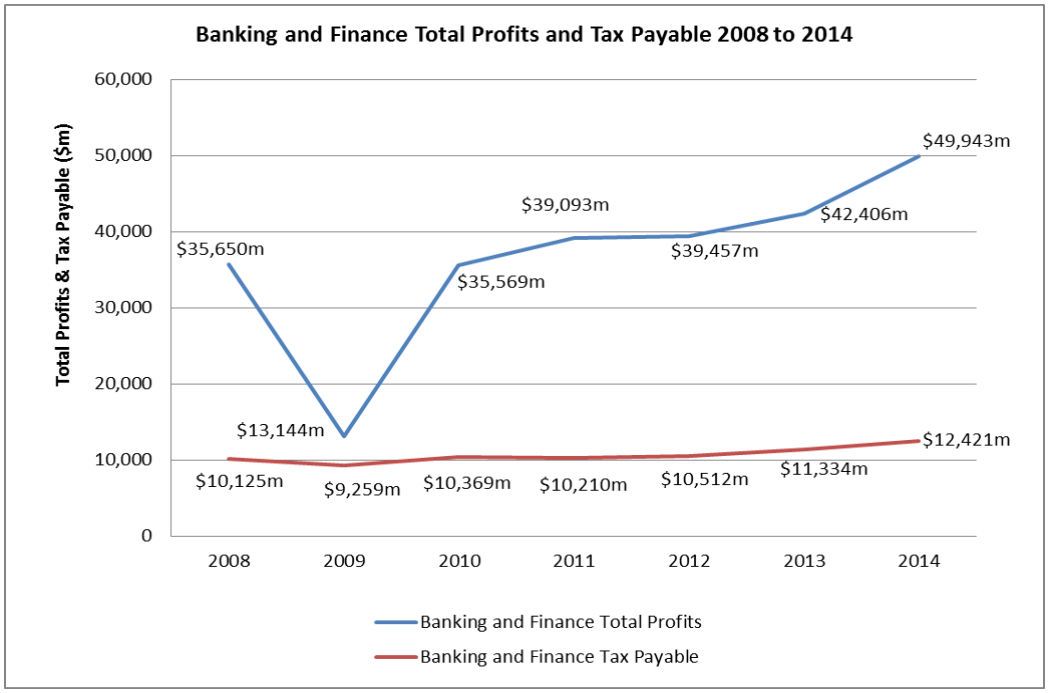
Department/Agency: ATO
Question: 7
Topic: Banking profitability
Reference: Hansard – page 6
Question:

Mr RUDDOCK: I have two questions. First, in relation to the way in which banking profitability has changed over time: when those very substantial increases in profitability have occurred has the tax paid by banks reflected that growth? What I am interested to know is whether the tax that is in fact payable is being—at a time of very high profitability—manipulated in any way. There are obviously corporations that have been able to manage their affairs so that they make large profits but do not pay a lot of tax. Have the banks' payments—without identifying particular banks but asking the question generally—reflected that increase in profitability?
Ms Carey: Obviously, that is subject to various timing and permanent differences that create those differences between accounting profits and tax payable. Certainly Australia's large corporates' effective tax rates are now published on an annual basis. They were published last December for the first time—I would need to refresh my memory on what the numbers were for the banks; I will have to take that on notice. As for whether that has reflected a trend over the years, again, I suppose that would be disclosing particular taxpayer information around individual taxpayers' effective tax rates. To be honest, I would feel slightly uncomfortable in providing that information. However, I think you would get from those transparency figures, which now have to be provided and published annually, a better picture of how the tax payable reflects the profits of the individual banks from an accounting point of view.

Answer:

There has been a correlation between tax payable and profits over time within the banking and finance industry. There is a consistent medium to longer term trend of increases in profit being accompanied by higher tax liabilities.

Table 1



Parliamentary Joint Committee on Corporations and Financial Services

ANSWERS TO QUESTIONS ON NOTICE

Australian Taxation Office

Inquiry into impairment of customer loans

4 April 2016

Department/Agency: ATO
Question: 8
Topic: Suggestions for potential legislative changes
Reference: Hansard – page 6

Question:

Mr RUDDOCK: I would not want to let the opportunity pass without inviting you to consider the framework of law in which these issues are being dealt with. Given that we are a body that can recommend change to the law, does the Commissioner of Taxation have in mind particular changes and enhancements which we might be able to pursue to ensure that it is able to deal adequately with the full range of issues that this inquiry has brought forward? I am inviting you, if you think there are ways in which we should be legislating to improve the situation, to make those recommendations to us.
Ms Carey: Certainly I can feed that back to the office. This is specifically in relation to impairment?
Mr RUDDOCK: This inquiry goes to a range of issues that impact upon not only the banks and their profitability but also the situations of others and, I imagine, their tax affairs as well. We are concerned about whether or not particular tax implications might lead to different behaviour by the institutions in relation to the way in which they deal with their customers. That is why the questions were asked by my colleague earlier. I would be concerned if the way in which the taxation issues and the deductibility issues are dealt with by the banks could in fact encourage behaviour which might adversely affect these
Ms Carey: I will take that point on notice.

[Note: Confirmed suggestions for potential legislative changes are *in relation to the deductibility of bad debts or impaired loans*]

Answer:

The ATO has no evidence to suggest that banks are changing their behaviour in relation to their customers as a result of the current tax settings in relation to impaired loans.