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14 December 2012

Chair of the Board of Taxation
Attention: Mr Roger Paul, Secretary
The Treasury
Langton Crescent
PARKES ACT 2600

Response to Board of Taxation Discussion Paper of October 2012
Review of Tax Arrangements Applying to Permanent Establishments

Dear Chair,

We refer to your request for submissions in relation to the discussion paper titled "Review of Tax Arrangements Applying to Permanent Establishments" ("Discussion Paper"), dated October 2012. The attached Appendix A presents our submission in relation to the transfer pricing and broader taxation issues outlined in the Discussion Paper. Our comments are focused at a high level on key principles to address the issues identified in the Discussion Paper.

Our comments are provided in the spirit of mutual and transparent cooperation to ensure that Australia's domestic tax and transfer pricing rules operate effectively and align with international standards and global best practice.

We look forward to further consultation once the initial review has been completed, with ongoing dialogue and debate on the issues to ensure this matter is appropriately addressed.

If you have any comments or questions about matters contained in our response, please do not hesitate to contact the undersigned.

Yours sincerely,

PP

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Appendix A

1. Introduction

The Board of Taxation has been asked to examine and report on the advantages and disadvantages of Australia adopting the OECD functionally separate entity approach[1] to the attribution of profits to permanent establishments ("PEs"). To assist the Board in its deliberations, it has released a discussion paper which includes a number of specific questions on which it has requested comment.

Having reviewed the questions outlined in the Discussion Paper, we have outlined our comments within the following four broad categories:

1) **Consistency** implications arising in connection with the interests of various stakeholders:

   a) **Operational consistency** - business management issues arising from discrepancies between the internal processes and systems adopted by financial institutions which are generally maintained on a functionally separate entity approach, and the tax treatment of certain dealings with PEs if a single entity approach is followed.

   b) **Global consistency** - Double tax issues arising where the attribution of profits to PEs in Australia is inconsistent with the approach adopted by major trading partners (ensuring global consistency of approach).

   c) **Regulatory consistency** - capital allocation issues arising where the allocation for regulatory purposes is inconsistent with the attribution of capital for determining the attribution of profits to a branch.

2) **Economic** implications of implementing a functionally separate entity approach:

   a) The potential for notional dealings to be recognised for Australian transfer pricing purposes and whether this would distort the functional profile of the legal entity and its PEs.

   b) Whether uncontrolled comparable data is available to price notional dealings.

   c) How would an entity substantiate the functional profile of its branches and the occurrence of notional dealings (also referred to as "qualifying internal dealings")?

   d) Implications for Australian tax revenues, having regard to the relevant transfer pricing considerations, and Australia's attractiveness as a financial centre.

3) **Tax** implications of implementing a functionally separate entity approach:

   a) Whether the functionally separate entity approach should form part of Australia's domestic legislation and/or Double Tax Agreements ("DTAs")?

[1] In this submission, we use the terms "functionally separate entity approach" and "authorised OECD approach" interchangeably.

b) Whether there will be a link between the characterisation of the dealing for attribution of profits and the characterisation for **all other tax purposes** (e.g. withholding tax obligations)?

c) Whether **insurance and reinsurance companies** should be brought within the general operation of Article 7 of Australia's DTAs?

4) **Policy** implications associated with implementing a functionally separate entity approach:

a) How the functionally separate entity approach could be **administered** (e.g. compliance issues, etc)?

b) The implications for Australia as a financial services centre.

We believe that the abovementioned categories effectively cover the queries and comments raised in the Discussion Paper. Therefore, our responses have been structured to address each of these categories with relevant questions then linked to these categories. Prior to addressing each issue, we will provide an indication of those questions raised in the Discussion Paper which in our opinion are relevant to the topic being discussed.

2. Discussion of key issues

The following discussion is structured in accordance with the broad issues identified in Section 1. For reference, the issues in connection with implementing the functionally separate entity approach are summarised as follows:

1. **Consistency** implications
2. **Economic** implications
3. **Tax** implications
4. **Policy** implications

This section sets out the issues raised by the Discussion Paper which fall within each category, and provides a discussion which, while broader in scope than the specific questions, is intended to address the key issues raised.

2.1 Consistency implications

2.1.1 Operational consistency

> ***Q 5.2 Issues/Questions***
> *The Board seeks stakeholder comments on:*
> - *the effects that the adoption of the authorised OECD approach would have on:*
>   - *Australian multinational enterprises carrying on business through offshore branches in key trading and investing destinations; and*
>   - *foreign groups investing into Australia.*

Impact on taxpayer's internal systems and processes

With respect to current systems, processes and pricing methodologies used to evidence and price cross-border internal dealings, we expect that adopting the authorised OECD approach would not require onerous costs and/or resources to change/adapt taxpayer's financial accounting and other information systems and business processes.

For example, in the banking sector, branches are generally set up as separate entities or business units in their financial accounting and other information systems. This enables the banks to track external revenues earned and operating expenses incurred by each branch as well as track internal dealings (e.g. notional loans and derivative transactions) that are recorded to assist in the calculation of an arm's length amount of profits for the bank and its branches. These internal dealings are entered into having regard to the functions performed, assets employed and risks assumed by the bank and its branches. A similar functionally separate entity approach is also generally adopted by non-bank enterprises that operate in foreign jurisdictions through branches.

The functionally separate entity approach still has regard to the fact that a branch is not legally separate from the enterprise of which it is part of and that this has economic consequences that are relevant in determining an arm's length attribution of profits - for

example, a branch has the same creditworthiness as the rest of the enterprise of which it is part of.

2.1.2 Global consistency

> ***Q 4.1 Issues/Questions***
> *The Board seeks stakeholder comments on:*
> - *whether there are other countries which are likely to adopt the new Article 7 in their bilateral tax treaties.*
> - whether there are reasons other than those given by the United Nations Committee of Experts (see paragraph 4.32) for certain countries not adopting the new Article 7 in their bilateral tax treaties.
> - whether there are any examples of inconsistent application between domestic tax law and tax treaty policy in countries adopting the new Article 7.

> ***Q 7.1 Issues/Questions***
> *The Board seeks stakeholder comments and information on the practical application of the authorised OECD approach if it is adopted in Australia. Specific questions and details which will assist in assessing the advantages or disadvantages of doing so include:*
> - *The current systems, processes and pricing methodologies used to evidence and price cross-border internal dealings that (if they were with a third party would be a financial transaction) and the extent to which (if any) there may be a need to adjust the prices in order to appropriately comply with the authorised OECD approach (refer, in this regard, to paragraph 4.5 of this discussion paper).*
> - *What are the compliance cost implications of adopting the authorised OECD approach with respect to:*
>   - *the requisite systems and processes that taxpayer entities would need to have in place?*

Significance of other countries adopting the authorised OECD approach

Like Australia, a number of countries are considering the adoption of the new Article 7 in their bilateral tax treaties and the authorised OECD approach in interpreting the business profits Article in their bilateral tax treaties. As noted in the Discussion Paper, these countries include a number of Australia's existing tax treaty partner countries, namely the United States, the United Kingdom, Switzerland, Canada, Germany and the Netherlands.

The significance of these countries to Australia, the global economy and to the international financial services sector cannot be understated as highlighted by the following facts:

- the United States (1), the United Kingdom (2), the Netherlands (4), Switzerland (5), Canada (7) and Germany (8) are each in the top 10 major source countries for Foreign Direct Investment ("FDI") in Australia.[2]

[2] Source: Australian Financial Markets Association, 2011 Australian Financial Markets Report.

- the United States, the United Kingdom, Canada and Germany are four of the eight G8 nations - the G8 nations comprise 42.5% of 2011 Global Domestic Product ("GDP");[3]
- the United States (1), the United Kingdom (3), Germany (4) and Switzerland (8) are each in the top 8 largest banking centres[4];
- the United Kingdom (1), Germany (2), the United States (3), the Netherlands (7) and Switzerland (8) are each in the top 8 origins of cross-border transactions[5]; and
- the United States (1), the United Kingdom (4), Germany (5) and Canada (8) are each in the top 8 in Insurance Market Share by OECD countries[6].

Having regard to these facts, it is crucial that Australia adopts an approach to determining an arm's length attribution of profits to PEs that is consistent with the approach adopted by key nations to:

- ensure that the potential risk of double taxation is minimised; and
- eliminate the additional compliance burden associated with maintaining different accounting records (where multinational corporations operate through branches in jurisdictions that generally accept the authorised OECD approach); and
- reduce the complexity and resources required with respect to operational transfer pricing matters.

Other than those nations identified in the Discussion Paper, we are not aware of any other nations that have publicly communicated their position on whether or not to adopt the authorised OECD approach.

Reasons for not adopting the new Article 7

We understand that the United Nations Committee of Experts decided not to adopt the authorised OECD approach because "it was in direct conflict with paragraph 3 of Article 7 of the United Nations Model Convention which generally disallows deductions for amounts "paid" (other than toward reimbursement of actual expenses) by a permanent establishment to its head office."[7] Further, the commentaries note that the "rule is seen as continuing to be appropriate in the context of the United Nations Model Convention"[8].

We are not aware of any other reasons why countries would not incorporate the new Article 7 in their bilateral tax treaties when they are renewed or renegotiated.

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[3] Source: http://en.wikipedia.org/wiki/G8; GDP figures derived from purchasing power parity calculations.

[4] Source: International Financial Services London ("IFSL") Research, Banking 2010.

[5] Ibid.

[6] Source: OECD, StatExtracts; http://stats.oecd.org/Index.aspx?DatasetCode=INSIND

[7] United Nations (2011), Model Double Taxation Convention between Developed and Developing Countries, Commentary to UN Model Article 7.

[8] Ibid.

Domestic law vs new Article 7

We are not aware of any examples of inconsistent application between domestic tax law and tax treaty policy in countries adopting the new Article 7.

2.1.3 Regulatory consistency

> ***Q 5.1 Issues/Questions***
> *The Board seeks stakeholder comments on the impacts and implications of Australia adopting the authorised OECD approach and, if it does so, how it should do so and what issues would need to be considered as a consequence of doing so.*
> *Specific issues in this regard include:*
> - *whether there should be special rules in Australia for capital allocation to branch operations in Australia adopts the authorised OECD approach?*

> ***Q 6.1 Issues/Questions***
> *The Board seeks stakeholder comments on:*
> - *whether compliance with the foreign bank's home regulator's rules with respect to capital allocation are relevant to establish compliance with the requirements of the authorised OECD approach by Australian branches of foreign banks?*
> - *what are the implications of the constant changes to the operational environment and prudential regulatory environment for banks to the application of the authorised OECD approach?*

> ***Q 6.4 Issues/Questions***
> *The Board seeks stakeholder comments on the following issues if Australia were to apply the business profits article to insurers:*
> - *Would there be circumstances where there would be a conflict between the tax and regulatory attribution of risk to the branch?*
> - *What rules should apply if there would be a conflict between the tax and regulatory attribution of risk to the branch?*

> ***Q 6.5 Issues/Questions***
> *The Board seeks stakeholder comments on:*
> - *whether there should be special rules in Australia for capital allocation to branch insurance operations if Australia adopts the authorised OECD approach?*

The reports that are provided to APRA are generally based on the functionally separate entity approach. These reports are critical in demonstrating that the bank has met capital adequacy requirements. Given the importance of capital allocation in the attribution of profits to branches it would be prudent that the approach is consistent with the approach used for regulatory purposes. If this consistency is not achieved, there is a risk of a mismatch of capital allocation for regulatory purposes and the capital allocation for profit attribution in Australia. This inconsistency can then lead to double taxation where the other jurisdiction is following the functionally separate entity approach.

2.2 Economic implications

2.2.1 Transfer pricing considerations

Q 6.2 Issues/Questions
The Board seeks stakeholder comments relating to internal derivatives and foreign currency gains and losses in respect of the recognition of qualifying internal dealings, particularly in terms of the requirements set out in the 2010 OECD Report for their tax recognition and having regard to the terms of reference.
Views are specifically sought on:

- the circumstances in which an internal derivative could be considered to reflect an economically significant real and identifiable event capable of being recognised as a qualifying internal dealing under the authorised OECD approach;
- the circumstances in which a foreign currency gain or loss ought to be recognised under the authorised OECD approach; and
- whether granting Australian tax recognition for internal derivatives, and foreign currency gains and losses that might arise from the recognition of qualifying internal dealings, may pose risks to the revenue collected from taxpayers and, if so, how those risks could be managed.

Recognition of qualifying internal dealings

In terms of the single entity approach versus the functionally separate entity approach, we understand that there may be a concern that there are cases where an entity could create notional dealings with its PE that may distort the functional profile of the legal entity which then impacts the profits that would be attributed to the PE.

The counter argument to the above is that any notional dealings entered into under the functionally separate entities approach would only be recognised for the purpose of attributing profits on an arm's length basis where such dealings are consistent with the functions, assets and risks of the relevant parts of the entity. In our opinion, any potential "distortion" of the functional profile can be appropriately dealt with ensuring there are appropriate "threshold tests" for recognising notional dealings, as outlined in the OECD Report,[9] and by the application of the transfer pricing principles for transactions between separate legal entities.

In addition to the above, there is also a question as to whether such notional dealings are effectively incorporated within the single entity framework under the guidelines provided under TR 2001/11. Under these guidelines the determination of the profitability of the permanent establishment requires the use of a hypothetical separate entity. Therefore, the profitability under the single entity approach is effectively determined on a functionally separate entity basis. However, the mechanism for then arriving at this profit is through an administratively complex allocation of third party revenue and expenses of the entity. In this regard, notional dealings would appear to simplify the administratively complex allocations

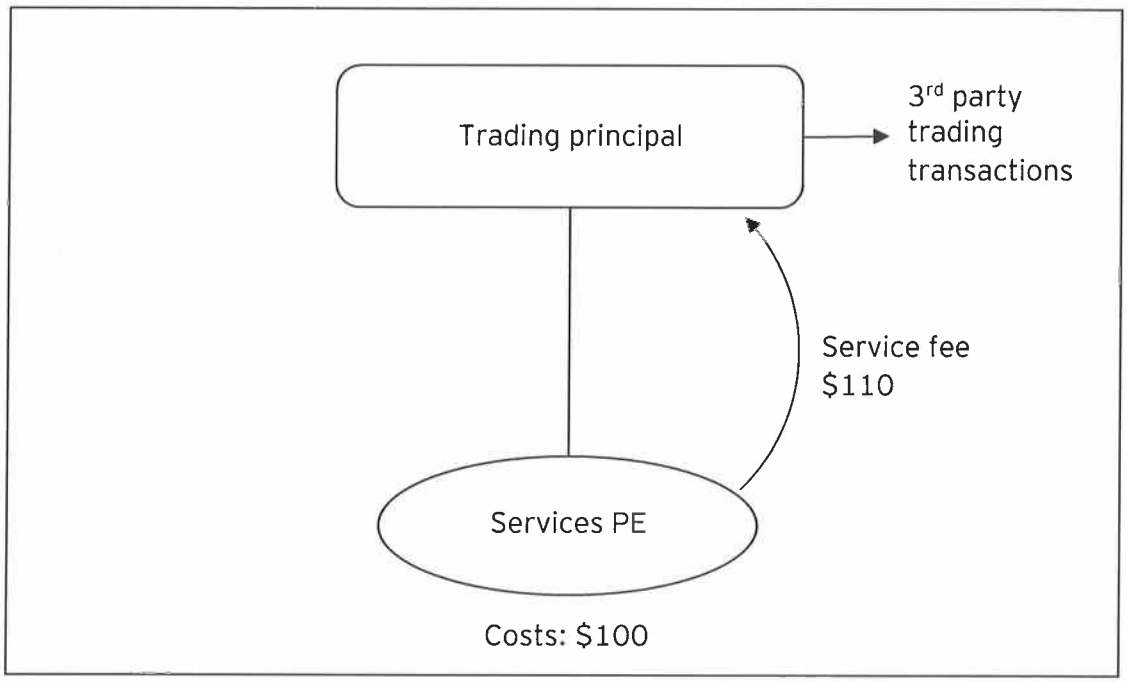
[9] OECD [2008], paragraphs 210-217.

required under the single entity approach whilst still maintaining the determination of the profits under a functionally separate entity approach.

To address the above, we have presented below several examples which consider the differences in the application of the single entity and functionally separate entities approaches to specific transactions, and have identified any potential distortionary impacts that may arise from the application of the functionally separate entities approach.

Example 1 - Services transaction

This is a simple example where the characterisation of the parties to the transaction is that the head entity acts as a trading principal, and the branch acts effectively as a services entity, providing (for example) marketing services in relation to the head entity's products. The decision to enter into the third party transactions solely rests with the head entity. The structure of the arrangement is outlined below.[10]



The ATO (single entity) approach to the above is to allocate some of the external revenue to the services PE, in line with what would have been earned by the PE operating as a separate entity. The alternative is to simply remunerate the PE as if it is an arm's length separate entity, based on its functional profile.

A summary of the outcome under the single entity approach is presented in the table below.

[10] It is noted here that TR 2001/11 explicitly excludes management and administrative services (as opposed to core services as in the above example) from attracting a mark-up, and indicates that these costs should be allocated between the entities at cost.

Approach	Single entity	Entity allocation		
		Head entity	PE	Consolidated
Revenue	1,000	890	110	1,000
Costs	(800)	(800)		(800)
PE Costs	(100)		(100)	(100)
Profit	100	90	10	100

In effect, the allocation of the external revenue in this manner is equivalent to the application of a services fee charged from the PE to the head entity, and it is this notional dealing which is created under the functionally separate entity approach, as summarised in the table below.

Approach	Separate entity		
	Head entity	PE	Consolidated
Revenue	1000		1000
PE service charge	(110)	110	
Costs	(800)	(100)	(900)
Profit	90	10	100

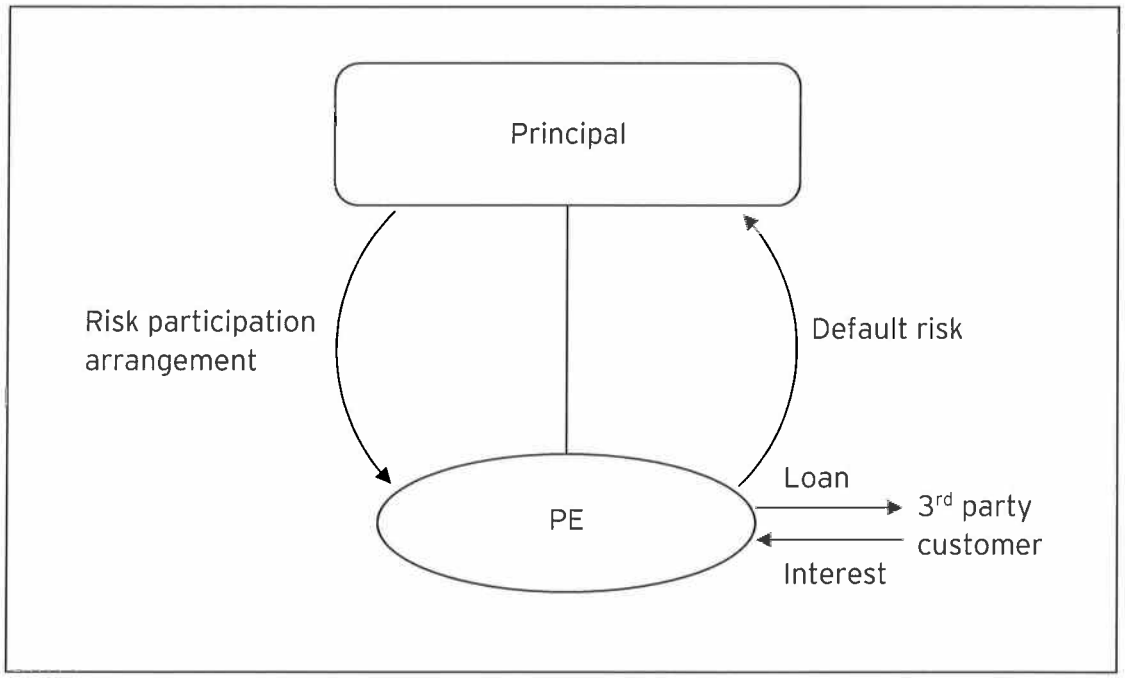
From an economic perspective, the outcome under both approaches is identical. Further, using this example, neither the total profit of the single entity nor the taxable position of either of the individual entities is distorted under the functionally separate entity approach.

As a final point, it is noted here that, even in this simple example, the functionally separate entity approach is administratively simpler than the single entity approach. Further, any additional revenue or deductions created under the functionally separate entity approach are already implicitly included in the single entity approach, by virtue of the way in which the external revenue and expenses are allocated between the parties.

Example 2 – "Risk participation" arrangements

The previous examples consider the impact on a PE's taxable position from the creation of various notional "expense" items. In the case of a "risk participation" arrangement, the question is instead one regarding the re-allocation of revenues.

In essence, a risk participation arrangement transfers the default risk of an external borrower from the branch to the head entity. This concept is illustrated in the diagram below.



The interest income earned by the PE in the above example may be considered as being priced to include the cost of funding, the default risk associated with the customer, the marketing cost incurred by the branch and the administrative cost of servicing the loan, with the remaining balance representing the profit attributable to the loan transaction. In a case where the branch and the head entity are considered functionally separate and the head entity assumes the default risk having regard to its functional profile, the branch accounts would consist of the following line items:

Line item	Indicative PE accounts
Interest income	100
Interest expense	(50)
Interest margin	50
Risk participation fee	(25)
Operating expenses	(20)
Profit	5

In such a case, the interest margin represents the return for the default risk associated with the customer, the marketing cost incurred by the branch and the administrative cost of servicing the loan. Where the head entity has assumed (and is subsequently managing) the default risk, the only remaining functions of the branch are the marketing and administration functions associated with the loan. The profit margin retained by the branch should therefore be representative of an arm's length return associated with these functions. The risk participation fee is calculated in order to leave an arm's length return in the branch. Note that, in this case, the functional profile of the branch reduces to that of a services entity, which was considered in Example 4.1.

We understand that there may be concerns with this approach, specifically that the risk participation arrangement represents a separation of the default risk from its associated function (being the making of loans). However, this is not the case in this example where the functions and risks associated with managing the default risk clearly rest with the head entity. In this case, the above approach ensures the total profit is allocated based on the functional profiles of the head entity and its PE.

Further to the above, it can be seen from the table below that the single entity approach could produce the same result as the functionally separate entity approach. In this case, it would be necessary to separately identify that component of the external interest income which relates to the default risk of the external party, and allocate this revenue to the head entity.

Approach	Single entity	Entity allocation		
		Head entity	PE	Consolidated
Interest income	100	25	75	100
Interest expense	(50)		(50)	(50)
Interest margin	50	25	25	50
Operating expenses	(20)		(20)	(20)
Profit	30	25	5	30

Clearly this is a simplistic example, and ignores any of the costs incurred by the head entity in association with assuming and managing the default risk (e.g. personnel costs, hedging costs, costs of default, etc). This example is intended to demonstrate only that the single entity approach, properly applied, could produce a similar outcome to the functionally separate entity approach.

In practice, of course, applying the single entity approach in the manner outlined above is likely to be either difficult or impossible. Further, the single entity approach assumes it is possible to either trace each branch lending dealing back to an external borrower, and to subsequently allocate the external revenues and expenses between the branch and the head entity based on their respective functional profiles. This approach is likely to be infeasible for most taxpayers, and particularly for multinational financial institutions, which enter into a significant number of these transactions on a daily basis.

In this regard, the "functionally separate entity approach", in which a transaction is hypothesised between the head entity and the branch, provides an administratively easier solution to the profit allocation problem, while still resulting in materially the same outcome.

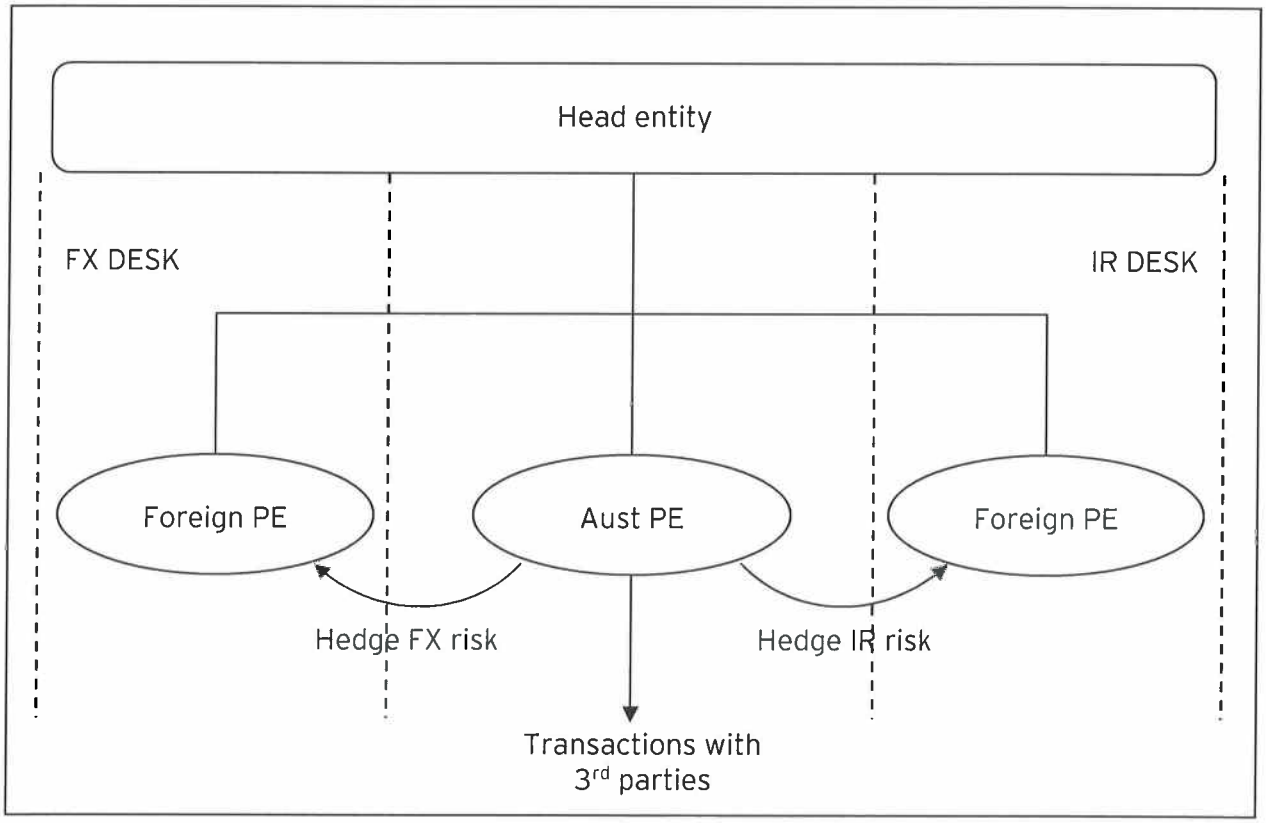
Example 3 – Derivatives trading

Building on the complexity of the previous examples, a more "real world" scenario for banks operating through global branch networks is outlined below:

- An offshore non-resident bank markets derivative and other products to clients around the world.
- It has people in locations in branches around the world. These branches perform both marketing and trading functions.

- The products sold by the bank are not generally available in the same form on exchanges. The bank breaks down the transaction into its individual risk components and traders in locations around the world will risk manage certain portions of unbundled risk.
- As part of this, Australian traders will risk-manage Australian risks.
- This approach is undertaken for a variety of reasons including cross-hedging or netting out the global risk incurred by the bank and maintaining a constant position in global markets.
- Global funding is retained by the head office in a general pool which can be used for any purpose around the world. Funding is often not specifically traced.
- Gains or losses arising in respect of the positions entered into by a trader in any one location cannot be ascertained in isolation. In fact, it is practically impossible to attribute results to any individual trader or calculate the gain or loss on a transaction from anything other than a global perspective.

The above situation is illustrated in the diagram below. Note that the "desks" referenced in the diagram below would in reality sit across a number of jurisdictions, and depending on the circumstances, a given transaction may even be hedged by the relevant "desk" within the Australian branch. The diagram is intended simply to provide a visual summary of the above information, and indicate that any one transaction may involve entities in multiple jurisdictions.



In the above scenario, risks may be hedged on a transaction-by-transaction basis, however it is far more likely that the individual risks will be managed on a globally aggregated net basis (i.e. only the net exposure relating to the global position will be hedged). As discussed above, it is therefore likely to be impossible to determine the revenue or profit to be allocated to an individual trader, or even an individual branch, by tracing and allocating the external revenues of the bank.

The only practical way to approach the above example from a transfer pricing perspective is to calculate the worldwide profit or loss on the global book and allocate the profit/loss based on a functional analysis of each of the participants.

While notional transactions need to be created to effect the profit/loss allocation between the head office and the branches, these transactions are created in order to practically implement an appropriate economic and transfer pricing approach and there is no mischief associated with the adoption of a separate entity approach.

Summary comments

We consider the functionally separate entity approach to be the most technically correct and administratively simple approach to determining the allocation of profits to PEs. We note that, as outlined in the various examples, the functionally separate entity approach generally produces profit results which are similar, if not identical, to the profit results which would have been achieved applying the single entity approach favoured by the ATO.

In this regard, we agree with the position outlined in the 2008 OECD Report on the Attribution of Profits to Permanent Establishments[11], being that the pricing of transactions relating to PEs should be identical to the pricing of the same transactions between separate legal entities. We note that differential treatment is currently possible under Australia's existing PE rules.

For the above reasons, we would strongly encourage Treasury to consider the functionally separate entity approach in drafting the revised attribution of profits to PE rules.

[11] Para. 77-79

Q 7.1 Issues/Questions

The Board seeks stakeholder comments and information on the practical application of the authorised OECD approach if it is adopted in Australia. Specific questions and details which will assist in assessing the advantages or disadvantages of doing so include:

- Will it be possible to find – in a cost efficient and objective manner – a comparable uncontrolled price for qualifying internal dealings? If so, please provide details of how this can be done?
- How would entities substantiate:
  - the split of functions, risks and use of assets between head office and PEs consistent with the authorised OECD approach;
  - that, consistent with the authorised OECD approach, a qualifying internal dealing (including services) has, occurred between a PE and head office; and
  - an appropriate pricing methodology for that qualifying internal dealing?
- What documentation and third party records are available to the ATO in Australia to review and establish arm's length pricing for the different types of cross-border qualifying internal dealings?
- How do commercial practices such as credit enhancement and collateralisation (for example, centralised Credit Support Agreements netting multiple exposures under derivatives across all operations including branch operations) affect the ability to determine an accurate arm's length price?
- Worked examples of how a range of commonly recorded internal dealings in financial arrangements (such as Australian dollar and foreign currency denominated internal loans and internal derivatives (swaps, forwards and options) as well as spot foreign currency transactions) would be treated for tax purposes under the functionally separate entity approach, as compared with the current Australian approach.
- The methodology (including inputs from market sources) for determining the rates and prices internally charged, including the circumstances and variables taken into account, for each of the following kinds of internal dealings recorded with respect to the entity's own branch operations:
  - internal funding or 'loans' (Australian dollar and foreign currency denominated);
  - internal derivatives (Australian dollar and foreign currency denominated);
  - spot foreign currency transactions; and
  - other kinds of internal dealings (for example, in relation to trading stock and capital assets).
- For the above, what would be the outcome if the functional currency is not the Australian dollar? For this situation, please provide examples for financial arrangements denominated in both the functional currency and other than in the functional currency.

Pricing qualifying internal dealings

With respect to qualifying internal dealings, it is our view that the pricing of such dealings would not be limited to the comparable uncontrolled price ("CUP") method but would depend on the selection and application of the most appropriate arm's length transfer pricing method. This includes the CUP method as well as the resale price method, the cost plus method, the profit split method and the transactional net margin method ("TNMM"). We would suggest that the selection of the most appropriate methodology would have regard to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines"), which considers such factors as the relevant facts and circumstances of the internal dealing and the availability of data on uncontrolled comparable data to determine an

arm's length price. In our opinion, the OECD approach to selecting the most appropriate transfer pricing method is not substantially different to the approach outlined by the ATO in Taxation Ruling TR 2001/11.

In light of the above, we do not anticipate there being any significant changes in the resources required and costs involved in selecting and applying the most appropriate transfer pricing method under the authorised OECD approach.

Substantiating the facts

The OECD Guidelines state that where the economic substance of a transaction differs from its form, then a tax administration may disregard the characterisation (or form) of the transaction and re-characterise it in accordance with its substance.[12] Therefore, even where a transaction occurs between legal entities which is documented in the form of a legal agreement, it is still necessary to understand and analyse the economic substance of the transactions as this will be relevant in determining an arm's length outcome for the parties to the transaction. This is generally addressed by performing a factual and functional analysis of the transaction.

Similarly, a factual and functional analysis would be required to substantiate:

- the split of functions, assets and risks between the head office and its PEs; and
- that a qualifying internal dealing has occurred.

The process involved in this is substantially no different to determining the economic substance of a transaction between separate legal entities.

The process of attributing functions, assets and risks to a PE would involve the principles outlined in the 2010 OECD Report, which has regard to identifying the location of where the significant people functions (or KERT functions for insurance enterprises) are performed.

The documentation and third party records that would typically be available to the ATO to review for qualifying internal dealings would include:

- The enterprise's internal transfer pricing policies which outline how the enterprise and its PEs set their transfer pricing arrangements in an effort to comply with the arm's length principle;
- Records of qualifying internal dealings executed in the enterprise's financial accounting and other information systems;
- Transfer pricing documentation prepared in accordance with the ATO's and OECD's guidelines, which would include a factual and functional analysis of the enterprise and the relevant PEs, the selection of the most appropriate transfer pricing methodology and the application of the selected methodology, including the relevant uncontrolled comparable data used to price or benchmark the qualifying internal dealing;

[12] OECD Guidelines [2010], paragraph 1.65.

- Agreements and other documentation evidencing third party dealings, which may be relevant to the extent that such third party dealings are comparable to the qualifying internal dealings;
- Documents prepared for regulatory and business management purposes;
- Financial accounts for the enterprise and its PEs that are prepared in accordance with generally accepted accounting principles;
- Organisational charts showing the people resources located in the relevant jurisdictions; and
- Email correspondence and other documented records which evidence the negotiations and decision-making process with respect to both third party transactions and qualifying internal dealings.

2.2. Broader economic implications

Q 7.2 Issues/Questions

The Board seeks stakeholder comments on:

- If Australia enters into a treaty that adopts the new Article 7, or adopts the approach more generally in domestic law, what is the likely impact on Australian tax revenue both in the short term and in the medium term taking into account a possible increase or decrease of use of PEs in Australia, particularly in the finance industry?
- What might be the behavioural impacts on Australian taxpayers in the short and longer term if Australia adopts the authorised OECD approach, in particular whether it would be possible and likely to lead to the potential relocation of certain functions or services, within an entity, towards jurisdictions with a lower tax rate?

Potential Australian tax revenue impact

We have not undertaken a detailed modelling exercise to quantify the potential Australian tax revenue impact of Australia adopting the authorised OECD approach and the new Article 7. However, as shown in the examples presented in this submission, we do not envisage Australia adopting the authorised OECD approach and the new Article 7 would produce any significant changes to Australia's tax revenue.

Potential for functions to transfer offshore

Multinational corporations review their global operations on an ongoing basis to address commercial objectives - e.g. deploy resources in a new market to exploit new business development opportunities or consolidate operations and resources to achieve operational and cost efficiencies. From a commercial and economic perspective, we do not expect that the use of a functionally separate entity approach, as compared to a single entity approach, would change the commercial decisions of multinational corporations or that the tax and transfer pricing outcomes arising from such decisions should be significantly different.

2.3 Tax implications

2.3.1Foreign Banks and Part IIIB

Q 8.1 Issues/Questions

The Board seeks stakeholder comments on:

- Your views on whether Part IIIB is consistent with the KERT and other requirements of the authorised OECD Approach (as set out in Chapters 4, 5 and 6 of this Discussion Paper)?
- If Part IIIB is not consistent with the requirements of the authorised OECD Approach, how Part IIIB should be amended to facilitate the authorised OECD approach?
- If Part IIIB is retained with a cap on the interest rate that can be charged on notional debt, which international benchmark rate would be the most appropriate, and why?
- If Part IIIB is retained but the LIBOR cap is removed, what would be the expected impact on:
  - the level of Australian tax paid on the profits of Australian branch operations of foreign banks and other qualifying financial entities?
  - banking competition?
- The methodology (including inputs from market sources) for determining the rates and prices internally charged by foreign banks to their Australian branches, including the circumstances and variables taken into account, for each of the following kinds of internal dealings recorded with respect to the entity's own branch operations and covered by Part IIIB:
  - internal funding or 'loans' (Australian dollar and foreign currency denominated);
  - internal derivatives (Australian dollar and foreign currency denominated);
  - spot foreign currency transactions; and
  - other kinds of internal dealings (such as capital assets).
- For the above, what would be the outcome if the functional currency is not the Australian dollar? For this situation, please provide examples for financial arrangements denominated in both the functional currency and other than in the functional currency.

Part III B of the Income Tax Assessment Act 1936 ("ITAA 1936")

Part IIIB of the ITAA 1936 currently deals with the taxation of income derived by foreign banks that operate in Australian through a PE. It is in effect an elective regime that essentially treats the Australian branch as a separate legal entity for tax purposes. This allows certain internal dealings (i.e. loans, derivatives and foreign exchange dealings) to be treated as if they were made between separate legal entities.

Whilst this captures some of the elements of the authorised OECD approach - the concept of a functionally separate entity and the recognition of internal dealings for Australian taxation purposes - it does not fully capture all of the relevant principles of the authorised OECD approach. For example:

- Only certain types of dealings are treated as if they were made between separate legal entities under Part IIIB. There are other common dealings between foreign banks and their Australian PEs that are not covered by Part IIIB (e.g. services, global trading books, and derivative transactions not included within the definition in section 160ZZV).

- Part IIIB refers to the notional transactions recorded in the branch's financial accounting records and does not specifically make reference to the need for a factual and functional analysis to be performed to determined whether the notional transactions are consistent with the concept of qualifying internal dealings, which would have regard to the functions, assets and risks of the Australian branch.

- Part IIIB caps the interest rate applied to the notional borrowings of the Australian bank branch to the applicable LIBOR rate for the currency of the funds borrowed. This does not consider whether the actual cost of borrowing for the Australian bank branch, having regard to the creditworthiness and cost of borrowing of the foreign bank and the applicable market rates for debt instruments with comparable terms.

We propose that the tax legislation be amended to reflect the following:

- That all notional transactions between the Australian bank branch and other parts of the foreign bank which satisfy the conditions of a qualifying internal dealing are recognised. In particular, the notional transactions that are consistent with the functions, assets and risks of the relevant parts of the bank should be given recognition as transactions that are respected for income tax purposes (within limits set out below).

- That all notional transactions are priced so that they result in an arm's length attribution of profits to the Australian bank branch.

The above principles should only be applied in calculating the taxable income of the Australian bank branch that is subject to Australian income tax. This would include, for example, through application of the rules in Division 230 of the Income Tax Assessment Act 1997 ("ITAA 1997"). However, these principles would not be applied for any other purposes, for example, withholding taxes, and should not necessarily require that the branch is deemed to be a legal entity separate from the foreign bank.

There are complicated issues that can emerge in relation to drafting legislation to give effect to the above. For example, the design of the rules and the extent of their application and interaction with other tax provisions will need careful attention.

It is not obvious to us that the amendment of, or continued reliance on, the framework provided by Part IIIB of the ITAA 1936 is the appropriate way to deal with these matters. As can be seen from the discussion at 2.3.3 below, the principles that we suggest to be applied in calculating the profit attributable to the Australian branch of a foreign bank should be the same as the principles to be applied in calculating the profit attributable to an overseas branch of an Australian bank. The profit attributable to the Australian branch of a foreign bank would be subject to Australian income tax, and the profit attributable to an overseas branch of an Australian bank should remain non-assessable non-exempt income. We believe that the legislative mechanism to achieve this should not necessarily require that the branch is deemed to be a legal entity separate from the rest of the bank. In our view, the legislative mechanism to achieve this can be one core set of rules for attributing profits to branches through recognition of qualifying internal dealings (in-bound and out-bound). This would eliminate the need for any on-going operation of Part IIIB in its current form.

We strongly recommend that a working group be established comprising members of Treasury, the ATO, business and the tax profession to advise on the design and drafting of any such legislative provisions.

We are of the opinion that no cap should be placed on the interest rate that can be charged on notional debt, unless this is merely a safe harbour against a Commissioner's adjustment which the Australian bank branch can elect to either apply or not apply. The use of a cap may not produce an arm's length outcome and therefore poses a potential risk of double taxation. If a cap is to be used (for the sole purpose of a safe harbour), we would propose the use of the applicable LIBOR (for foreign currency denominated notional debt) and/or BBSW (for Australian dollar denominated notional debt) plus an appropriate risk margin to be agreed through consultation with industry.

Methodologies for pricing internal dealings

You have requested details regarding the methodology for determining the rates and prices of internally charged by foreign banks to their Australian branches for certain kinds of internal dealings. In this regard we provide the following:

Notional transaction type	Most commonly used method	Source of data
Internal funding or loans	CUP method	Third party loan data (internal records) Third party debt instruments (Bloomberg)
Internal derivatives	CUP method	Internal trading systems used to price derivative instruments transacted with third parties
Spot foreign currency transactions	CUP method	Internal trading systems used to price derivative instruments transacted with third parties
Services	Cost plus method	Financial accounts maintained for the relevant parts of the bank and its branches External comparable data to benchmark the cost plus mark-up
Global trading books	Profit split method	Financial accounts maintained for the relevant parts of the bank and its branches

2.3.2 Incorporation of authorised OECD approach – domestic legislation vs tax treaties

Q 5.1 Issues/Questions

The Board seeks stakeholder comments on the impacts and implications of Australia adopting the authorised OECD approach and, if it does so, how it should do so and what issues would need to be considered as a consequence of doing so.

Specific issues in this regard include:

- should the authorised OECD approach be adopted on a treaty by treaty basis and, if that approach is adopted, the implications of having different rules in different treaties (and different respective commentaries to follow in applying those rules) or should Australia instead adopt the authorised OECD approach as part of Australia's domestic law for application in all circumstances, subject to conformity with any relevant treaty?

Authorised OECD approach - treaty or domestic law?

With respect to recent making changes to Australia's transfer pricing rules, the approach taken in drafting Subdivision 815-A of the ITAA 1997 and the Exposure Draft[13] which includes the proposed Subdivision 815-B of the ITAA 1997 has been to incorporate the OECD's Transfer Pricing Guidelines and Tax Administrations into the legislation as "guidance" for the purpose of applying the relevant Subdivisions. To this end, in the drafting of the proposed Subdivision 815-C of ITAA 1997 – Arm's length principle for permanent establishments, we would recommend a similar approach whereby the OECD's *2010 Report on the Attribution of Profits to Permanent Establishments* is included a "guidance" for the purpose of applying that Subdivision.

If alternatively the approach taken with respect to PEs is to wait until Australia renegotiates its international tax treaties, this is likely to cause significant delay and would appear to be unnecessarily different to the approach taken in drafting the new transfer pricing rules that apply to cross-border transactions between separate legal entities.

[13] Exposure Draft, Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of transfer pricing rules.

2.3.3 Other tax issues

Q 5.1 Issues/Questions

The Board seeks stakeholder comments on the impacts and implications of Australia adopting the authorised OECD approach and, if it does so, how it should do so and what issues would need to be considered as a consequence of doing so.

Specific issues in this regard include:

- what are the implications for the domestic tax law and for tax treaty policy of Australia adopting the authorised OECD approach?
- what principles should be followed in amending the income tax legislation if the Government were to adopt the OECD functionally separate entity approach?
- whether there should be special rules in Australia for capital allocation to branch operations if Australia adopts the authorised OECD approach?
- what would be the impact on current tax practices of adopting the authorised OECD approach?

These questions have been addressed in the discussion above. A summary of the conclusions with respect to these questions is summarised below.

- The domestic law would include the relevant OECD guidelines and commentary which are generally used for interpreting the business profits and associated enterprise articles in many of Australia's DTAs. Further, as opportunities arise to amend Australia's DTAs to more closely align with the functionally separate entity approach, this could also be undertaken to provide even greater certainty.

- The approach followed could be based on the approach used in the Subdivision 815-A and the Exposure Draft for the proposed Subdivision 815-B, where the OECD guidelines have been effectively written into the domestic legislation as "guidance" for the purpose of applying the relevant Subdivision.

- If the functionally separate entity approach is used and is consistent with the approach used for regulatory purposes, further consideration should be given as to the need for special rules in Australia to deal with capital and other regulatory-based allocations to branches. This is so as to ensure the potential for double taxation is minimised. In this regard, regulatory imposed costs arising from capital, liquidity or other prudential requirements should be able to be allocated on a sum-of-the-parts basis across branches so as to minimise the double taxation risk.

- Given the consistency of the functionally separate entity approach with the guidance provided in TR 2001/11 and the proposed Subdivision 815-C there would appear to be limited impact on current tax practice other than to provide greater certainty and reduce the administrative burden on taxpayers.

Q 5.2 Issues/Questions

- whether there are any particular issues that arise for stakeholders in applying the authorised OECD approach to:
  - deemed PEs (for example, PEs that do not arise through having a fixed place of operation, but through deeming provisions, including but not limited to, use of substantial equipment, dependent agent arrangements and supervisory activities); and
  - PEs created for a specific, single project of limited duration such as a construction project.
- for treaty cases, whether there are any circumstances in which double taxation of income from overseas PEs of Australian enterprises could occur if Australia enters into a treaty adopting the authorised OECD approach. If so, what are those circumstances and what amendments to section 23AH of the ITAA 1936 or Division 770 of the ITAA 1997 would be necessary to ensure double taxation would be relieved or avoided;
- in non-treaty cases, in the event that there is actual or potential double taxation, what amendments to section 23AH of the ITAA 1936 or Division 770 of the ITAA 1997 would be necessary to ensure double taxation would be relieved or avoided;
- in broad terms, the extent to which permanent establishments should be treated as subsidiaries for the purposes of the tax treatment of qualifying internal dealings. Particular questions in this regard are set out in the next two bullet points;
- if Australia adopts the authorised OECD approach in future tax treaties, should amendments be made to Australian domestic law to recognise 'notional' amounts charged on qualifying internal dealings (for example, notional rent, licensing payments, service payments, royalties, interest and foreign exchange gains and losses) for all Australian tax law purposes, for example:
  - calculating withholding tax payable by the foreign branch operations of an Australian resident on notional 'interest' or 'royalties' arising in accordance with the authorised OECD approach;
  - calculating the foreign branch income of Australian resident taxpayers under section 23AH and for the purposes of the foreign income tax offset rules; and
  - making whatever further specific adjustments are required to ensure that dealings between an Australian resident and its foreign PE are treated, to the extent possible, similarly to transactions between an Australian resident and a foreign subsidiary; or
  - as an alternative to the above, requiring an Australian resident entity to calculate the assessable income and allowable deductions arising from its Australian operations separately (instead of merely subtracting s 23AH branch profits from worldwide income), and for that purpose treating all recognised dealings between the Australian resident and its foreign PE, to the extent possible, similarly to transactions with a foreign associate.
- if Australia adopts the authorised OECD approach, should it make modifications to domestic law and the new Article 7 as necessary so that Australia would be able to apply the approach in the previous bullet point to an Australian PE of a foreign resident? This could include, for example:
  - calculating withholding tax payable by the Australian branch operations of a non-resident on notional 'interest' or 'royalties' arising in accordance with the authorised OECD approach.

In relation to overseas PEs of Australian banks, we are of the view that the tax legislation should be amended to reflect the following principles:

- That all notional transactions between the overseas branch and the head office and other parts of the bank which satisfy the conditions of a qualifying internal dealing be recognised. In particular, the notional transactions that are consistent with the functions, assets and risks of the relevant parts of the bank should be given recognition as transactions that are respected for income tax purposes (within limits as set out below).

- That all notional transactions are priced so that they result in an arm's length attribution of profits to the overseas branch.

The above principles should only be applied in calculating the taxable income of the overseas branch which is then subject to section 23AH of the ITAA 1936 as non-assessable non-exempt income and for the purposes of Division 770 of the ITAA 1997 as necessary to prevent double taxation. This would include, for example, applying the rules in Division 230. The above principles would not be applied for any other purposes, for example, withholding taxes.

We believe that implementation of the above principles does not require that the branch be deemed to be a notional foreign subsidiary company or a separate legal entity from the head office parent. This would lead to additional complications being introduced under the tax law, such as the interaction with the tax consolidation rules and the controlled foreign company rules. We think that it should be sufficient to apply the above principles to simply determine the calculation of the taxable income of the branch which is then non-assessable non-exempt income of the relevant Australian legal entity under section 23AH of the ITAA 1936.

As can be seen from the discussion at 2.3.1 above, the principles that we suggest to be applied in calculating the profit attributable to the overseas branch of an Australian bank should be the same as the principles to be applied in calculating the profit attributable to an Australian branch of a foreign bank. The profit attributable to the Australian branch of a foreign bank would be subject to Australian income tax, and the profit attributable to an overseas branch of an Australian bank should remain non-assessable non-exempt income. We believe that the legislative mechanism to achieve this should not necessarily require that the branch is deemed to be a legal entity separate from the rest of the bank. In our view, the legislative mechanism to achieve this can be one core set of rules for attributing profits to branches through recognition of qualifying internal dealings (in-bound and out-bound).

There are complicated issues that can emerge in relation to drafting legislation to give effect to the above. For example, the design of the rules and the extent of their application and interaction with other tax provisions will need careful attention. We strongly recommend that a working group be established comprising members of Treasury, the ATO, business and the tax profession to advise on the design and drafting of any such legislative provisions.

2.3.4 Insurance and reinsurance

Q 6.3 Issues/Questions

The Board seeks stakeholder comments on whether Australia should apply the authorised OECD approach to insurers, having regard to the existing tax treatment of insurers, including foreign insurers.

Specific questions in this regard are:

- Should Australia bring insurers within the general ambit of the business profits article in future treaties?
- If this happens, how should Australia deal with the following issues:
  - interpretation of the terms 'surplus' and 'reserves' in applying the authorised OECD approach to insurers.

Q 6.6 Issues/Questions

The Board seeks stakeholder comments on the following questions:

- Should Australia change its treaty policy and bring reinsurance within the general operation of the business profits article?
- If Australia changes its treaty policy and brings reinsurance within the general operation of the business profits article, how should the investment yield be determined if the amount of investment assets attributed to the branch operations is less than the amount of investment assets the branch holds?

Treatment of insurers

As noted in the Discussion Paper, Australia excludes the taxation of insurance and reinsurance enterprises under the business profits article, with certain exceptions (e.g. under the tax treaty with Germany, life insurance enterprises are not excluded). This can create significant difficulties for foreign insurance/reinsurance enterprises which operate in Australia through a PE given that the exclusion of the business profits article is likely to be unique to Australia and therefore a consistent approach cannot be adopted in that enterprises' determination of an arm's length attribution profits to its branch operations, including Australia. There is also the growing risk of potential double taxation given that certain nations are considering adopting the authorised OECD approach under their existing treaties which do not include the latest revision of the business profits article. In this regard, we are of the opinion that insurance/reinsurance enterprises should be taxed under the general principles of the business profits article where this is consistent with the direction being taken by key nations.

If insurance/reinsurance enterprises are no longer excluded from the application of the business profits article, we are of the opinion that Australia should adopt the guidelines outlined in the OECD's 2010 Report on the Attribution of Profits to Permanent Establishments ("OECD 2010 Report"), which in Part IV includes detailed guidance on the practical application of the principles of the authorised OECD approach to attributing profits to a PE of an insurance enterprise. These guidelines address such issues as the use of a functional and factual analysis to determine the functions, assets and risks attributed to the PE, the

recognition of internal dealings, and the relevance of key entrepreneurial risk-taking ("KERT") functions in relation to the assumption of insurance risk.

In the event that the bilateral tax treaties are amended to include insurance and reinsurance enterprises under the business profits article, we recommend that appropriate amendments be made to Division 15 of the ITAA 1936 and other relevant provisions.

2.4 Policy implications

2.4.1 Administration

Q 7.1 Issues/Questions

The Board seeks stakeholder comments and information on the practical application of the authorised OECD approach if it is adopted in Australia. Specific questions and details which will assist in assessing the advantages or disadvantages of doing so include:

- Would adopting the authorised OECD approach bring greater certainty to taxpayers and reduce compliance costs compared to the current Australian approach?
- Would adopting the authorised OECD approach reduce administrative costs compared to the current Australian approach?
- What are the compliance cost implications of adopting the authorised OECD approach with respect to:
  - the required documentation for taxpayers, having regard to the need noted in the 2010 OECD Report for greater scrutiny of internal dealings and the Commentary view that it is not intended to impost more burdensome documentation requirement on PEs compared to associated companies; and
  - the requisite systems and processes that taxpayer entities would need to have in place?
- What would be the effects of adopting the authorised OECD approach in terms of positioning Australia as a financial centre?

Impact on transfer pricing administrative compliance

In our opinion, Australia adopting the authorised OECD approach is likely to:

- **Provide greater certainty to taxpayers** - as more nations seek to adopt the authorised OECD approach under both existing and revised versions of the business profits article, any departure from this approach in Australia is likely to create uncertainty for taxpayers both with respect to the risk of double taxation as well as in terms of accessing comprehensive practical guidance on applying the arm's length principle with respect to the attribution of profits to PEs - i.e. the guidance provided by the ATO in applying the single entity approach is substantially less than the guidance provided by the OECD in the 2010 Report.

- **Reduce compliance costs compared to the current Australian approach** - the authorised OECD approach recognises qualify internal dealings for the purpose of determining an arm's length attribution of profits to PEs where such dealings are consistent with an arm's length attribution of functions, assets and risks between the legal entity and its PEs. This approach is consistent with common commercial practice, which for financial accounting

and other information systems treats PEs as separate legal entities to enable the recording of internal dealings which are consistent with the functions, assets and risks of the relevant parts of the enterprise. It also enables the taxpayer to adopt an approach to setting and reviewing arm's length transfer prices which is broadly similar to the approach employed for transactions between separate legal entities. Such an approach is commonly understood amongst enterprises, tax advisors and tax administrations. Alternatively, the current Australian approach requires to attribution of actual third party income and expenses consistent with the arm's length principle. For taxpayers operating in the banking sector, such an approach is practically impossible and administratively burdensome given the volume of transactions entered into with third parties.

- **Reduce administrative costs compared to the current Australian approach** – we anticipate the administrative costs of the authorised OECD approach would also be lower compared to the current Australian approach given its similarity to the approach employed for testing the arm's length nature of transactions entered into between separate legal entities (though we not that the authorised OECD approach still has regard to the differences in the economic realities between an enterprise dealing with its PE and an enterprise dealing with a separate legal entity). Also, the guidelines in the OECD Report provide substantial practical guidance on determining the attribution of profits to PEs. Should Australia continue to not endorse the authorised OECD approach, the burden will be on the ATO to develop more detailed transfer pricing guidelines for taxpayers to help reduce the uncertainty regarding the application of the Australian endorsed approach.

Impact on Australia as a financial centre

Having regard to the observations made above with respect to the potential benefits of adopting the authorised OECD approach, it is our view that they can only enhance the attractiveness of Australia as a financial centre.