Australian Government

The Board of Taxation

REVIEW OF TAX ARRANGEMENTS APPLYING TO PERMANENT ESTABLISHMENTS

A Report to the Assistant Treasurer

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The Board of Taxation
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FOREWORD

The Board of Taxation is pleased to submit this report to the Assistant Treasurer following its review of the tax arrangements applying to permanent establishments (PEs).

The Board has made 14 observations commenting on the advantages and disadvantages of Australia adopting the functionally separete entity (FSE) approach to the determination of profits attributable to a PE, with the last one of these providing some concluding observations, and a recommendation regarding the appropriateness of having the London Interbank Offer Rate (LIBOR) cap as a safe harbour for the interest rate that may be charged for the use of internal funds by foreign banks in their Australian branches.

The Board established a Working Group of its members, chaired by Annabelle Chaplain, and comprising Chris Jordan AO (until his appointment as Commissioner of Taxation in 2013), Teresa Dyson and John Emerson AM to conduct the review. The Board issued a discussion paper, held discussions and targeted consultation meetings with a range of stakeholders, both before and after the release of the discussion paper, and received eight written submissions, two of which were confidential. The Board would like to thank all of those who so readily contributed information and time to assist in conducting the review.

The Board would also like to express its appreciation for the assistance provided to the Working Group by Ian Fullerton, Michael Johnston, Paul Hooper and Tony Frost as members of the Expert Panel, by Professor Richard Vann, Bob Jones and Satyajit Das as consultants engaged by the Working Group, and by officials from the Treasury and the Australian Taxation Office.

The *ex officio* members of the Board — the Secretary to the Treasury, Martin Parkinson PSM, the Commissioner of Taxation, Mr Chris Jordan AO, and the First Parliamentary Counsel, Mr Peter Quiggin PSM — have reserved their final views on the observations and recommendation in this report for advice to Government.

Teresa Dyson
Chair, Board of Taxation

Annabelle Chaplain
Chair of the Board's Working Group
Member, Board of Taxation

EXECUTIVE SUMMARY

The terms of reference asked the Board to advise on the advantages and disadvantages of Australia adopting the functionally separate entity (FSE) approach to the determination of profits attributable to a permanent establishment (PE).

There are two different approaches to the application of Article 7 of the OECD's Model Tax Convention on Income and Capital, which deals with the determination of profits attributable to a PE. These are referred to as the relevant business activity (RBA) approach and the functionally separate entity (FSE) approach.

Under the RBA approach, the 'profits of an enterprise' refer only to the profits of the business activity in which the PE has some participation. Article 7 is interpreted under this approach as imposing a limit on the profits that can be attributed to a PE, namely to the profits that the whole enterprise earns from the relevant business activity. In turn, the profits of the whole enterprise are those it earns from transactions with third parties and from associated entities (subject to the application of the transfer pricing rules to the latter).

The FSE approach provides for the PE to have a greater degree of independence from the rest of the enterprise of which it is a part. Under the FSE approach, Article 7 is interpreted as not limiting the profit attributed to the PE to that of the whole enterprise.

The Board has made 14 observations commenting on the advantages and disadvantages of Australia adopting the FSE approach.

A key advantage of Australia adopting the FSE approach, which is of particular relevance to banks, is that the FSE approach would more explicitly and directly allow recognition of all internal derivatives that meet specified thresholds. The Board has noted that not taking account of internal derivatives as part of the attribution of profits to a PE has the potential to produce results that would not reflect the significant economic and commercial activities of a banking PE and could potentially result in volatile tax revenue outcomes.

Also, to the extent that some of Australia's top two-way trading partners also adopt the use of the FSE approach in practice for the purposes of allocating profit to PEs, it would assist the goal of Australia being a financial centre as it would be consistent with that practice.

A key disadvantage of adopting the FSE approach is that it could impose material additional compliance costs for entities in the non-financial sector and for small to medium sized entities.

The tax revenue impact of adopting the FSE approach is not clear, particularly if the law is not amended to ensure symmetric treatment of notional income and expense accounts for both the PE and the Australian resident entity.

The Board has noted that an advantage of adopting the new Article 7 on a treaty by treaty basis is that it would allow the Government to restrict the provisions of the FSE approach to those jurisdictions that agree to apply those provisions on a reciprocal basis. However, a disadvantage of adopting the new Article 7 on a treaty by treaty basis is that it could take a considerable amount of time for treaties to be amended to incorporate the new Article 7, potentially resulting in a diversity of outcomes, including for non-treaty countries which would remain unaffected by FSE adoption in treaties only.

An option which would assist in restricting the diversity of outcomes would be to introduce amendments to the domestic law to reflect the more limited FSE approach (as per the 2008 OECD Commentary on the old version of Article 7), which could be supplemented with bilateral negotiations with treaty partners.

The Board has noted that adopting the FSE approach in full in domestic law would require consideration of the policy and law design in respect of a number of significant features of the FSE approach, including the treatment of royalties, rent and interest (for non-financial institutions), the treatment of capital (including whether to amend Australia's thin capitalisation rules) and the allocation of economic ownership of assets as between a PE and other parts of the entity of which the PE is a part.

In this regard, the 2010 OECD report on the attribution of profits to PEs, while very informative on the conditions which give rise to the need to consider the FSE approach and on the approach of the FSE in the context of a transfer pricing framework, is not intended to be, nor is it, prescriptive on what policy settings are required to implement the FSE approach in a country's domestic law. Nor does it provide detailed specific guidance on how to apply the FSE approach in practice. The lack of guidance may result in complexities and uncertainties in its application to particular situations.

The Board has noted that a more targeted option that the Government may wish to consider would be to adopt the FSE approach for financial institutions. This could be done through a modernisation of Part IIIB of the *Income Tax Assessment Act 1936* (ITAA 1936), which would include its extension to Australian financial institutions and increasing the scope of the provision to cover financial arrangements as defined in Division 230 of the *Income Tax Assessment Act 1997* (ITAA 1997). This targeted option would not impose the compliance requirements of the FSE approach on non-banks and small to medium sized entities.

To the extent that common commercial practice of banks is consistent with the FSE approach, the FSE approach has the potential to not impose undue compliance costs on that sector. It would also provide more certainty for banks, particularly with respect to their treatment of internal derivatives.

The Board has emphasised, as part of adoption of the FSE approach, the importance of documentation relating to internal dealings, including derivatives, that is appropriate to the particular situation, requiring greater scrutiny than might otherwise be required for transactions between associated enterprises but generally not being such as to impose costs and burdens disproportionate to the circumstances. It has noted that documentation needs to be consistent with, and support, the FSE's required functional and factual analysis, which should demonstrate the economic and commercial significance of the relevant dealings.

Apart from the consideration of whether Australia should adopt the FSE approach, the Board has noted that priority should be given to asking the Commisioner of Taxation to provide guidance, under the current law, on whether and how internal derivatives, including those that are manged on a portfolio basis, may be sufficiently evidenced for recognition for tax purposes. If useful administrative guidance cannot be provided by the Commissioner under the terms of the current law, legislative changes should be considered to provide the required certainty.

The Board observes that the economic and financial environment in which multinational enterprises operate has been changing, and continues to change rapidly. Since the OECD's work started on the FSE approach, relevant conditions have continued to evolve. This has implications for the design of any changes to implement the FSE approach; it would need to cater for ongoing change.

The Board does consider that the FSE approach takes a more direct approach to dealing with the ways in which risk is allocated and managed within sophisticated multinational enterprises than more traditional approaches that start with the profits that the whole enterprise earns from the relevant business activity and impose a limit on the profits that can be attributed to the relevant PE. That said, the tax recognition of internal dealings under the FSE approach is not without some potentially complex administrative difficulties. Should the FSE approach be implemented, fully or in part, robust administrative safeguards would be an important design feature.

The Board recommends that, subject to confirmation that the removal of the LIBOR cap would result in no material cost to tax revenue, the cap should be removed. That would assist in fostering competition in the domestic market. That recommendation should be implemented only in the context of adopting the FSE approach for financial institutions and not as an isolated amendment to Part IIIB of the ITAA 1936.

CHAPTER 1: INTRODUCTION

BACKGROUND

1.1 On 24 May 2012 the Assistant Treasurer and Minister Assisting for Deregulation, the Hon David Bradbury MP, announced that he had commissioned the Board to investigate the impacts of Australia adopting the functionally separate entity (FSE) approach to the attribution of profits to permanent establishments (PEs).

1.2 As part of the review, the Board was additionally asked to review the current special rule that limits the deemed interest deduction on internal funds used by foreign banks in their Australian branches to the London Interbank Offer Rate (LIBOR).

1.3 The Board has been asked to consult extensively with stakeholders and to report to the Assistant Treasurer by 30 April 2013.

1.4 As part of the background for the review, the Government noted that in July 2010, the OECD approved a new Article 7 (Business Profits) and Commentary for the Model Tax Convention on Income and on Capital, which incorporated a new authorised approach to the attribution of profits to PEs (of which the most common example are branches).

1.5 The new Article 7 more clearly hypothesises the PE as a separate enterprise from the enterprise of which it is a part and applies usual transfer pricing principles, subject to the required functional analysis determining the recognition of relevant 'dealings' between the PE and the enterprise's other operations. The new Article 7 Commentary recognises economic differences between PEs and subsidiaries and the new Article is not intended to achieve equality between PEs and subsidiaries in all respects. The 2010 OECD Report on the Attribution of Profits to Permanent Establishments (the 2010 OECD Report) explains in detail how to apply the new authorised approach, which it refers to as the 'functionally separate entity' approach.

1.6 Australian tax law currently allocates actual income and expenses of the taxpayer to a PE using functional analysis and applying the arm's length principle by analogy. Australia has not made a Reservation on new Article 7 or an Observation on its Commentary but none of Australia's concluded tax treaties incorporate new Article 7. Tax treaties continue to be negotiated on the basis of the former OECD Model Article 7, pending final decisions on the FSE approach.

1.7 The issue of attribution of profits to PEs is especially relevant to the finance sector, where branches are used in part for regulatory reasons. Given the significance of this sector and the Government's objectives in enhancing Australia's status as a leading regional financial centre, it is important that the policy settings be carefully considered. Of course, PEs are a feature of other industries and policy in this area will have to give appropriate weight to impacts beyond the finance sector.

1.8 Policy making is complicated by the fact that countries have not universally adopted the new Article 7, or the relevant Commentary. A number of OECD countries (including New Zealand) have entered reservations in respect of the change and the United Nations Committee of Experts on International Cooperation in Tax Matters has not viewed changes as relevant to the United Nations Model Convention. Importantly a number of key economies (Brazil, China, Hong Kong, Indonesia, Malaysia, Thailand and India) are known to have reserved their position on the new Article 7.[1]

1.9 On 1 November 2011, the Treasury released a Consultation Paper 'Income tax: cross border profit allocation — Review of transfer pricing rules' examining the need to rewrite Australia's tax law concerning profit allocation. That Paper contained a section dealing with the attribution of profits to PEs in which Treasury sought views on the desirability of adopting the new OECD approach in treaty and non-treaty cases. Treasury also sought views on any potential revenue implications of adopting the new OECD approach. Most submissions did not comment on this aspect and those that did said that in practice little revenue impact would be expected.

Terms of reference

1.10 Against the above background, the Board was asked to examine and report on the advantages and disadvantages of Australia adopting the FSE approach to the determination of the profits attributable to a PE in its tax treaty negotiations and in the domestic law.

1.11 In making this assessment, the Board was asked to consider:

- Overall policy objectives for cross border profit allocation: profits attributed to the Australian tax base should appropriately reflect economic activity undertaken in Australia and as far as practicable the relevant rules should be aligned with and interpreted consistently with international standards.[2]

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1 Complicating matters further, it is understood some countries consider the revised Article 7 Commentary is consistent with the wording of the former Article 7. Consequently they may interpret treaties based on the former Article 7 consistently with the revised Commentary. They may consider it unnecessary to change their treaty practice to adopt the new Article 7.

2 See Income tax: Cross Border Profit Allocation — Review of Transfer Pricing Rules, The Treasury 1 November 2011, paragraphs 25 – 27.

- Implications for granting relief from double tax for Australian multinational enterprises in respect of their income taxable in an offshore branch country under the new OECD Article 7.
- Evidence on the emergence of, and likely development of, the FSE approach as a new international standard. In light of this evidence, the Board might also consider the extent to which adoption of the FSE approach would:
  - affect Australian multinational enterprises in carrying on business through offshore branches in key trading and investment destinations; and
  - benefit foreign groups investing into Australia.
- Short-term and long-term impacts on taxation revenue of possible options in the context of the Government's fiscal position and strategy.
- Implications for the domestic law and for tax treaty policy of adopting the FSE approach and in particular whether the approach should be adopted:
  - on a treaty by treaty basis and, if so, the implications of having different rules in different treaties (and respective commentaries to follow in applying those rules); or
  - as part of Australia's domestic law for application in all circumstances, subject to conformity with any relevant treaty.
- Whether adopting the FSE approach would bring greater certainty to stakeholders and reduce compliance and administrative costs.
- Specific implications in the practical application of the FSE approach and for compliance with relevant methodologies including:
  - whether granting Australian tax recognition for particular intra-entity dealings that meet the requirements of the new OECD Article 7 may pose risks and how those risks could be managed. Internal derivatives and foreign currency exchange rate gains or losses are two areas that should be examined in particular; and
  - any special requirements for businesses both in the finance and non-finance sectors, and the corresponding implications for the administration of the law, in relation to the functional analysis and evidence required to meet the OECD standard for recognition of their intra-entity dealings.

1.12 The Board was also asked to advise what principles should be followed in amending the income tax legislation if the Government were to adopt the OECD FSE approach. In particular, this advice should cover the implications of adopting the new approach for the special rules dealing with Australian PEs of foreign financial institutions.[3] The Board's report could usefully include worked examples of how a range of intra-entity dealings in financial arrangements commonly undertaken (such as internal loans, internal derivatives and foreign exchange arrangements undertaken by financial entities) would be treated for tax purposes under the FSE approach.

LIBOR cap on intra-entity loans

1.13 Specific to the finance sector, the Board was additionally asked to review the current special rule that limits the deemed interest deduction on internal funds used by foreign banks in their Australian branches to the LIBOR. This rule was introduced as part of the elective arrangement that allows foreign banks to claim deductions for deemed interest in respect of the internal funding of the Australian branch.

1.14 Australia as a Financial Centre: Building on our Strengths ('the Johnson Report') noted that in periods of financial stress there can be appreciable differences between LIBOR and commercial rates for inter-bank lending. In the context of retaining this specific domestic rule, the Johnson report recommended the removal of the limitation and reliance on the usual transfer pricing rules to determine the amount of the deemed interest deduction.[4]

1.15 The Board was asked to advise on the continued appropriateness of having a safe harbour for the interest rate that may be charged for the use of internal funds by foreign banks in their Australian branches, as a proxy for arm's length interest rates, and if so the suitability of the LIBOR cap for that role. This advice should take account of, among other things, the impact of any change to the cap on banking competition and on tax revenues.

1.16 The Board of Taxation is required to provide the Government with a report on these issues by 30 April 2013.

REVIEW PROCESSES

1.17 The Board's consultation process has involved:

- preliminary consultations with a range of stakeholders;
- the release of a discussion paper in October 2012 to invite and facilitate submissions; and
- holding targeted consultation meetings with a number of key stakeholders, following the release of the discussion paper.

3 Part IIIB of the Income Tax Assessment Act 1936.

4 The Senate Economics Committee Inquiry into the Banking Sector has also called for a review of the LIBOR cap.

Submissions

1.18 The Board received eight written submissions, including two confidential submissions, in response to the discussion paper.

Board's report

1.19 The Board has considered the issues raised by stakeholders in their submissions and at the consultation meetings, and the views of the members of the Expert Panel. However, the Board's recommendations reflect its independent judgment.

CHAPTER 2: USE OF PERMANENT ESTABLISHMENTS IN AUSTRALIA

DRIVERS, TYPE OF ACTIVITIES AND SIZE RELATIVE TO SUBSIDIARIES

2.1 As further background to the review, the Board sought comments from stakeholders on the reasons for using a PE rather than a subsidiary, the type of activities undertaken by and channelled through PEs and the size or extent of use of PEs relative to any subsidiaries that particular businesses use.

Views in submissions

2.2 Feedback on this topic was received primarily from The Tax Institute (TTI) and the Australian Financial Markets Association (AFMA). Submissions in general confirmed the significant use of PEs in the finance sector, in part for regulatory reasons. With respect to the non-financial sector, particular references were made to the use of PEs in activities providing services to the resources industries, including through the provision of substantial equipment.

Reasons for using a permanent establishment rather than a subsidiary

2.3 TTI noted that the reasons an organisation may use a PE rather than a subsidiary are many and varied, including:

- flexibility in the start-up phase of a business;
- the type of industry in which an organisation operates (for example banking and insurance); or
- the type of business engaged in by an organisation, such as using an asset in a specific location for a short period of time without the requirement to establish a local presence (that is subsidiary) each time and transfer/dispose of assets.

2.4 AFMA noted that banks generally look to utilise PEs for their overseas operations for a variety of commercial reasons in addition to regulatory requirements. With respect to the latter, AFMA noted that the Banking Act requires that retail banking businesses must be placed in a locally incorporated entity (that is a subsidiary) as this provides the appropriate level of depositor protection. It asserted that for banks that operate a wholesale only business, the prudential regulation of foreign bank branches provides a level of regulatory intensity that is more in keeping with the nature of their business.

The type of activities undertaken by and channelled through permanent establishments

2.5 TTI noted that the type of activities ordinarily undertaken by a PE will vary depending on the industry in which the organisation operates. Examples include:

- services provided to the resources industries on a 'turnkey' basis, where the majority of work occurs overseas and the last phase of work is in Australia (for example a pipeline or a Liquefied Natural Gas train);
- an Australian principal contractor of a global services provider that sub-contracts with the various entities within the global organisation;
- the 'beachhead' type of operations used in the funds management industry to facilitate service delivery and provide client-facing support in a particular jurisdiction on a temporary basis;
- an employee of a foreign fund manager living in Australia to operate in the 'Asia-Pacific' time zone; and
- banking and insurance businesses that use their assets to support the operations of their branches in any location.

The size or extent of use of permanent establishments

2.6 With respect to the size or extent of use of PEs in the financial sector, AFMA noted that as of October 2012, foreign bank branches held 7.9 per cent of the share of bank assets, which was double that of foreign bank subsidiaries.

2.7 AFMA also noted that the market share of foreign bank branches has fallen by almost half since the onset of the Global Financial Crisis (GFC), reversing their balance sheet rapid growth prior to the GFC that had the effect of reducing business loan margins. It explained that this was largely due to the contraction by European banks, with Japanese and other Asian banks exhibiting significant growth in their balance sheets.

Board's consideration

2.8 The Board notes that PEs are significantly used in the financial sector, in part but not exclusively for regulatory reasons, but also by businesses in the non-financial sector, particularly by entities engaged in providing services to the resources industries.

2.9 The Board notes that this review deals with the attribution of profits to PEs and not with whether a PE exists. With respect to the latter, the Board recommended in its report on the *Review of an investment manager regime as it relates to foreign managed funds* that a foreign managed fund should not be taken to have a PE in Australia if the only reason it would have a PE is because it uses an Australian intermediary (Recommendation 3).

2.10 PEs engaged in providing services to the resources industries could involve the use of substantial equipment. The Australian Taxation Office (ATO) has considered some aspects of attribution in relation to substantial equipment PEs under the current law in its ruling on the attribution of profits to PEs, TR 2001/11.

2.11 The Board has obtained limited feedback on the implications of the adoption of the FSE approach from businesses involved in the provision of services to the resources industries. However, as part of the limited feedback received, it has been noted that adoption of the FSE approach may imply material additional compliance costs for some of these businesses, for example where the PE is temporary in nature.

2.12 The Board notes that in considering the advantages and disadvantages of the adoption of the FSE approach, potential compliance costs for businesses in the non-financial sector, including those involved in the provision of services to the resources industries through the use of substantial equipment, need to be taken into account.

Observation 1:

The Board notes that:

- PEs are significantly used in the financial sector, in part but not exclusively for regulatory reasons, but also by businesses in the non-financial sector.
- In considering the advantages and disadvantages of the adoption of the FSE approach, potential compliance costs for businesses in the non-financial sector, including those involved in the provision of services to the resources industries through the use of substantial equipment, need to be taken into account.

CHAPTER 3: CURRENT AUSTRALIAN APPROACH

ATTRIBUTION OF PROFITS TO PES UNDER THE CURRENT AUSTRALIAN APPROACH

3.1 The Board's discussion paper contained a brief summary of:

- how current Australian income tax law generally applies to business operations carried on through a PE in Australia by a non-resident;
- how the current tax law applies to provide relief from any double taxation of income from business operations carried on through the offshore PE of Australian residents; and
- the specific tax rules that apply to the Australian branch operations of foreign banks and other financial entities.

3.2 On 13 February 2013, transfer pricing reforms were introduced into the House of Representatives as Schedule 2 to the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*. These reforms modernise Australia's domestic transfer pricing rules, currently contained in Division 13 of Part III of the ITAA 1936, to better align them with international best practice as set out by the OECD. As part of these reforms, Schedule 2 inserts Subdivision 815-C into the ITAA 1997.

3.3 The object of Subdivision 815-C is to ensure that the amount brought to tax in Australia by foreign entities operating at or through PEs is not less than it would be if the PE were a distinct and separate entity engaged in the same or comparable activities under the same or comparable circumstances, but dealing wholly independently with the entity of which it is a part. The existing PE attribution rules in Division 13 of Part III of ITAA 1936 are based on the same principle. Consistent with the framework of the new Division 815, proposed Subdivision 815-C provides more detailed guidance on the attribution of income (including gains) and expenses (including losses) to a PE.

The operation of the current approach regarding PE attribution, including for internal derivatives

3.4 The ATO provided the following advice to the Board on how the current approach operates regarding PE attribution, including for internal derivatives.

3.5 The framework principles for determining taxable income attributable to business operations carried on through an Australian PE of a foreign resident are:

- Principle 1 — assessable (gross) income and expenses/costs are attributed, not net 'profit';
- Principle 2 — only actual income and expenses/costs can be attributed;
- Principle 3 — amounts are characterised under Australian tax law;
- Principle 4 — functional analysis is undertaken (income is attributed to the place(s) of key activities/decision making that produce the income);
- Principle 5 — assets follow functions (the location of assets used in income producing functions follows the location of income producing functions);
- Principle 6 — risk follows functions/assets (the location of risk follows the location of activities that produce income); and
- Principle 7 — funding/costs follows functions (losses or outgoings are characterised by reference to the income to which they relate).

3.6 In relation to business operations carried on overseas by an Australian resident the above principles apply in determining:

- the foreign income derived by the Australian resident in carrying on business at or through a foreign PE for the purposes of applying section 23AH of the ITAA 1936 (that is, for determining if any of that income is exempt);
- which of the Australian resident's losses or outgoings are incurred in deriving that income (that is, determining deductibility of any such losses or outgoings); and
- if there are any foreign income tax offsets that may be allowable for that income.

3.7 The ATO provided the following details as to how it applies the framework principles in practice, including for internal derivatives:

- The income or profits attributable to a PE are determined by functional analysis (Principle 4);
- An internally recorded 'derivative' or other 'arrangement' is not solely relevant in itself in determining the income or profits attributable to a PE. This follows from Principle 1, as well as Principles 2 to 7. What is relevant is what has actually occurred (that is, functional analysis — Principle 4).

- No functionally relevant fact or event has occurred if internally recorded 'currency swaps' and 'cross-currency interest rate swaps' do not reflect the terms of actual (external) swaps entered into by the non-resident for its PE's business,[5] unless and until funds are actually transferred between separate parts of the entity.

- The ATO has provided guidance to taxpayers in TR 98/11 on the documents required to support their functional analysis. However, it is necessarily the case that the ATO is not limited to particular kinds of evidence in verifying the affairs of taxpayers and can have regard to any relevant evidence such as interviews, third party records etc.

3.8 For completeness, the ATO noted that the administrative rules about actual interbranch trading stock transfers and actual interbranch funds transfers by banks in the ordinary course of their business are examples of the application of Principle 2. The particular business circumstances covered by those administrative rules enable the prescribed proxy to be used for attributing income to the supplier of the trading stock or of the funds, respectively, where the criteria for applying the rule are satisfied.

3.9 The ATO noted that, although there have not been ATO public statements specifically dealing with how income or expenses/costs of 'hedging' transactions are attributed to PEs, it would apply the framework principles having regard to the following:

- A hedge is an internally designated relationship between two different positions or 'exposures'. In other words, what makes a transaction a 'hedge' is not the kind of transaction the entity enters into with the counterparty, but the designation by the entity of that transaction as a hedge against another of the entity's external transactions or assets/liabilities.

- When an external transaction is designated as a hedge against another pre-existing exposure from the entity's transactions or assets/liabilities, the intention is to limit risk arising from the pre-existing exposure. The 'risk' of the pre-existing exposure is thereby 'managed'.

- Risk management by 'hedging' therefore occurs prospectively[6]. Otherwise there is no purpose to reduce an exposure in the requisite sense. This can be contrasted with a situation in which two different exposures may have offsetting effects, such as a natural hedge.

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5 Determined by applying functional analysis and the other Principles.

6 For example, accounting standard AASB 139 require that a hedge relationship be designated prospectively.

- Because the hedge reduces a pre-existing risk, the effects of the hedge instrument must follow the hedged item. That is, whoever bears the risk of the hedged item also bears the 'counter-risk' of the hedging instrument.

3.10 The ATO has advised that applying Principle 6 and Principle 7 therefore means that gains or losses from such 'hedging' transactions are attributed to the same place as the transaction or asset/liability which is being hedged.

The ATO view on advantages of the current approach to attributing profits to PEs

3.11 The ATO has submitted to the Board the following three advantages of the current approach to attributing profits to PEs:

- the current approach, or relevant business activity (RBA) approach, attributes the entity's actual income and expenditure, minimising speculation and hypothesis;
- the functional analysis focuses on what was actually done to earn income and whether it was done in business carried on through a PE; and
- the application of 'risks follow function/assets' ensures income from activities/decisions cannot be shifted or 'hived off' to another location to reduce global tax.

3.12 The ATO has stated that an approach which requires hypothesising what income would be derived in certain circumstances, or hypothesising what costs would be incurred in certain circumstances, introduces an element of speculation, and hence uncertainty and resulting risk in taxation administration and taxation outcomes. The ATO further states that the degree of risk is affected by the nature of factual variability in the relevant kind of transaction or 'dealing', and the sensitivity of pricing to such variability. Transactions involving the use of intellectual property and financial derivatives are noted as examples for which there is a high variability and price sensitivity.

3.13 With respect to functional analysis, the ATO has submitted that it would introduce a significant integrity risk to adopt an approach which allocates income based on the act of documenting a notional internal dealing rather than on whether the documented dealing was evidence of actual business operations of the branch. It submits that any such approach would mean that the tax treatment of business operations would be based on the choice of whether or not to document an internal dealing. If internal documentation were assumed to be sufficient 'evidence' in itself for the purposes of attribution of profits, significant revenue would be at risk.

3.14 The ATO argues that it is common sense that liabilities and consequences arising from a transaction/activity are attributed to the same operations as the transaction or activity. It notes that this means that neither the revenue nor taxpayers can separate or 'strip' income or liabilities, for tax purposes, from the assets or activities giving rise to the income or liabilities and argues that the principles in the 2010 OECD report on attribution of profits could be expected to prevent bifurcation or 'splitting' of 'risks' from single assets/contracts.

Proposed Subdivision 815-C

3.15 As noted above, Division 815 modernises and redesigns Australia's domestic transfer pricing rules. The *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* proposes the introduction of Subdivision 815-C, which would replace the PE attribution rules in Division 13 of Part III of ITAA 1936.

3.16 Paragraph 4.2 of the Explanatory Memorandum to the Bill introducing Subdivision 815-C states that the new PE attribution rules reflect the approach to the attribution of profits to PEs that is currently incorporated into Australia's tax treaties, namely the RBA approach.

3.17 Consistent with the framework of Division 815, Subdivision 815-C provides direct access to the relevant OECD guidance material to ensure better alignment between Australia's PE attribution rules and current treaty practice. In particular, proposed section 815-235 of ITAA 1997 requires 'arm's length profits' and 'arm's length conditions' to be determined 'so as best to achieve consistency with' the prescribed guidance material which include the OECD's Model Tax Convention on Income and Capital, and its Commentaries, as adopted by ... [the OECD] and last amended on 22 July 2010, to the extent that document extracts the text of Article 7 and its Commentary as they read before 22 July 2010.

3.18 Subdivision 815-C recognises elements of the FSE approach to the extent that they are consistent with current treaty practice. In particular, the two step approach to identifying 'dealings' between a PE and other parts of an enterprise, and allocating 'remuneration' to such dealings is recognised but the Subdivision stops short of deeming the results of internal dealings to be 'income' and 'expenses'. Instead, the results of those dealings are taken into account in allocating the 'real' income and 'real' expenses of the entity to the PE.

3.19 It is noted that Subdivision 815-C operates only for the purpose of increasing taxable income or reducing losses or credits available to the taxpayer. This is also the case for the existing PE attribution rules in Division 13 of Part III of the ITAA 1936. If internal dealings are to be used as a guide in allocating income and expenses to a PE, there would still be a need for guidance under the RBA approach as to which specific items of income and expenses are to be allocated to the PE and how they are to be identified. It is also noted that Subdivision 815-C would not apply to an Australian PE of a foreign financial institution if Part IIIB of the ITAA 1936 applies, even though the scope of Part IIIB is limited to only certain types of intra-entity dealings.

Board's consideration

3.20 The Board concurs that the RBA approach, as incorporated in Australian law and into Australia's tax treaties, requires attribution to a PE of the actual income and expenditure/costs actually derived/incurred by the taxpayer in its transactions with third parties.[7] The attribution under the RBA approach does not of itself exclude consideration of dealings between the PE and the rest of the enterprise of which the PE is a part and, indeed, should take account of such dealings. However, the FSE approach more explicitly and directly permits recognition of qualifying internal dealings as part of the attribution of profits to a PE.

3.21 The Board is of the view that there is nothing in the FSE approach which would permit recognition of qualifying internal dealings solely on the basis of accounting records or other documentation without the corresponding functional and factual analysis substantiating a real event.[8] Appendix C explains, by reference to an internal derivative dealing example, the importance of a functional and factual analysis supported by appropriate documentation.

3.22 Similarly, the Board is of the view that a discussion of the risk management functions and the circumstances in which the transfer of risks between parts of an enterprise could be recognised in the context of a traditional banking business appears in Part II of the 2008 OECD report on the attribution of profits to PEs (see paragraphs 174 to 184). Part III of that report, which deals with global trading activities of financial institutions, may also not prevent bifurcation or 'splitting' of 'risks' from single assets/contracts when functions are split between locations as substantiated by proper functional and factual analysis. In fact, Part III provides references on the circumstances where a risk from a single transaction could be managed in different parts of an entity and notes that, depending on the hedging methods used, there are difficulties in identifying particular transactions as hedges of other transactions.

3.23 In the context of the RBA approach, the only 'administrative solutions' provided by the ATO are for internal transfers of trading stock and for actual internal transfers of funds in the ordinary course of banking business that are analogous to transfers of trading stock. If the criteria for these administrative solutions are met, the ATO accepts that the pricing of an internal dealing will produce an appropriate allocation of actual income and expenses.

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7 Appendix C describes in more detail where the RBA approach can differ in outcome from the FSE approach.

8 Paragraph 177 (page 48) of the 2010 OECD *Report on the attribution of profits to Permanent Establishments* states that 'The starting point for the evaluation of a potential "dealing" will normally be the accounting records and internal documentation of the Permanent Establishment … and ultimately it is the functional and factual analysis which determines whether the dealing has taken place, not the accounting records or other documentation provided by the enterprise'.

3.24 The Board notes that the ATO ruling dealing with international transfer pricing — operation of Australia's permanent establishment attribution rules — does not address PE attribution issues that are of importance to, or are particular to, financial institutions, including capital allocation for multinational banks, interbranch lending and global trading.[9] PE attribution issues related to income tax and branch funding for multinational banks were subsequently addressed by TR 2005/11, but there has not been a separate ruling dealing with the other identified issues that are of importance to, or are particular to, financial institutions.

3.25 The Board recognises that there are circumstances where it becomes practically impossible to trace the particular inputs drawn from one PE into the sale of a finished product. Even in the case of the transfer of finished goods between head office and a PE tracing becomes difficult in many cases. As a result, the ATO has noted that, where there has been an actual transfer of funds or trading stock to or from branch operations in the ordinary course of the business carried on through the branch, it may be necessary to determine an arm's length attribution of the actual income and costs attributable to the transferred funds or trading stock based on the transfers recorded in the accounts. This is on the proviso that the accounts have been properly prepared and the attribution outcomes are the best estimate of PE profits that can be made in the circumstances.

3.26 The Board is of the view that tracing difficulties are also present in the case of internal derivative dealings or arrangements, particularly for those that are managed on a portfolio basis, and that specific guidance would assist in providing clarity on how the law should be applied in this area.[10] In this regard, the Board considers that there is currently considerable uncertainty about the operation of the income tax law in this area.

3.27 With the administrative trading stock solution in mind, the Board accordingly submits that consideration be given to asking the Commissioner of Taxation to provide guidance, under the current law, on whether and how internal derivatives, including those that are managed on a portfolio basis, may be sufficiently evidenced for recognition for tax purposes, provided that:

- a functional analysis reveals that the internal derivatives represent economically significant activities undertaken by the PE and the rest of the bank in relation to the management of the risks generated in the course of the bank's business; and
- the attribution of income and expenses to such economically significant activities is on an arm's length basis.

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9 As noted at paragraph 6 of TR 2001/11.

10 Appendix C explains diagrammatically the tracing issues relating to internal derivative dealings and the importance of appropriately taking these dealings into account as part of the attribution of profits to a PE.

3.28 The ATO has advised that the Commissioner can provide guidance on how the principles of the current approach apply to economically significant activities reflected in internally recorded 'derivatives'. If useful administrative guidance cannot be provided by the Commissioner under the terms of the current law, legislative changes should be considered to provide the required certainty.

Observation 2:

The Board notes that:

- The current Australian approach requires attribution to a PE of the actual income and expenditure/costs actually derived/incurred by the taxpayer in its transactions with third parties. The attribution under the RBA approach does not of itself exclude consideration of dealings between the PE and the rest of the enterprise of which the PE is a part and, indeed, should take account of such dealings. However, the FSE approach more explicitly and directly permits recognition of qualifying internal dealings as part of the attribution of profits to a PE.

- There is nothing in the FSE approach which would permit recognising qualifying internal dealings solely on the basis of accounting records or other documentation without substantiating the corresponding functional and factual analysis.

- The guidance contained in the OECD report on the attribution of profits to PEs may not prevent bifurcation or 'splitting' of 'risks' from single assets/contracts when they are substantiated by proper functional and factual analysis.

- Consideration should be given to asking the Commissioner of Taxation to provide guidance, under the current law, on whether and how internal derivatives, including those that are managed on a portfolio basis, may be sufficiently evidenced for recognition for tax purposes.

- If useful administrative guidance cannot be provided by the Commissioner under the terms of the current law, legislative changes should be considered to provide the required certainty.

CHAPTER 4: THE FUNCTIONALLY SEPARATE ENTITY AS A NEW INTERNATIONAL STANDARD

4.1 The terms of reference asked the Board to consider evidence on the emergence of, and likely development of, the FSE approach as a new international standard.

4.2 The Board's discussion paper noted that several of Australia's existing tax treaty partner countries (including Canada, Germany, the Netherlands, Switzerland, the United Kingdom and the United States) may seek to adopt new Article 7 in their future tax treaties.

4.3 It was, at the same time, noted that only a limited number of recently concluded treaties adopt the new Article 7. These include the 2012 Germany Luxembourg, 2012 Germany Netherlands, 2012 United Kingdom Barbados and 2012 United Kingdom Liechtenstein tax treaties.

4.4 On the other hand, the discussion paper noted that the United Nations Committee of Experts on International Cooperation in Tax Matters has rejected the FSE in its Model Double Taxation Convention between Developed and Developing Countries. The Committee of Experts decided not to adopt the FSE 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 PE to its head office.

4.5 The discussion paper also noted that the following jurisdictions do not support and have expressly reserved their position on adopting the OECD Model new Article 7: Argentina, Brazil, Chile, Greece, Hong Kong, India, Indonesia, Latvia, Malaysia, Mexico, New Zealand, the People's Republic of China, Romania, Serbia, South Africa, Thailand and Turkey (of which Chile, Greece, Mexico, New Zealand and Turkey are OECD members). Portugal also reserved its right to continue to adopt the previous version of the OECD Model Article 7 text until its domestic law is adapted in order to apply the new approach.

4.6 Against the above background, the Board sought comments from stakeholders 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 for certain countries not adopting the new Article 7 in their bilateral tax treaties and whether there were any examples of inconsistent application between domestic tax law and tax treaty policy in countries adopting the new Article 7.

Views in submissions

4.7 Submissions in general confirmed the preliminary findings conveyed in the discussion paper. Ernst & Young noted that other than those nations identified in the discussion paper, they were not aware of any other nations that have publicly communicated their position on whether or not to adopt the FSE approach.

4.8 The Australian Bankers Association (ABA) noted that of the 5 OECD member countries which have expressed reservations, only New Zealand has particular relevance to Australian banks in terms of PE operations. It claimed that funding transactions with New Zealand branches are afforded the FSE approach under Australian tax rulings. In view of this, the ABA does not anticipate significant issues between Australian and New Zealand operations if Australia adopts the FSE approach and New Zealand continues to reserve its current position.

4.9 AFMA's view is that adoption of the new Article 7 and, more generally, the FSE approach will become the international standard.

4.10 No examples of inconsistent application between domestic tax law and tax treaty policy in countries adopting the new Article 7 were reported in the submissions.

Board's consideration

4.11 The Board notes that, so far, only a limited number of countries have concluded treaties adopting the new Article 7 (and with it the full FSE approach) and understands that it is normal for model tax treaty innovations to take some time to be adopted in actual treaties.

4.12 The Board is of the view that a decision for Australia to adopt the FSE approach should not be solely based on the extent of the current take-up of new Article 7 but also on whether the FSE approach is a conceptually sound approach that would bring benefits to Australia.

4.13 A measure of the conceptual soundness or otherwise of an attribution approach is to consider the potential distortionary outcome if internal derivative dealings are not appropriately taken into account in profit attribution. This is considered by way of an example in Appendix C.

4.14 A conceptually sound approach would involve greater certainty for stakeholders, reduced compliance and administrative costs, a fair revenue outcome for Australia, assist in the achievement of reducing double taxation and less than single taxation internationally, and support the goal of Australia being a financial centre.

4.15 A limited FSE approach was adopted in the 2008 OECD Commentary on old Article 7 and some countries may seek to adopt that limited FSE approach in their bilateral treaties based on old Article 7. It may be that others wish to adopt the limited

FSE approach in their domestic law and agree on the full FSE approach in bilateral treaties concluded on the basis of the new Article 7. Others may reserve their adoption of new Article 7 but accept elements of the FSE approach in practice.

4.16 The Board notes that there is still very limited international experience from jurisdictions that have been administering the FSE approach. At the same time, the experience from administration of the arm's length principle as applied to associated entities, which the FSE approach draws ideas from, may prove useful guidance when considering the administration of the FSE approach. Further, the Board understands that the OECD has a large scale transfer pricing simplification project underway, including revision of the guidelines to allow a broader use of safe harbours, which should assist in getting workable outcomes for small and medium enterprises (SMEs) and in gaining acceptance of the FSE approach by other jurisdictions.

4.17 As noted at Chapter 5, there is limited specific OECD guidance on how the FSE approach applies in practice, which may contribute to an initial low take-up of the FSE approach as a new international standard. The lack of guidance may also result in complexities and uncertainties in its application to particular situations.

Observation 3:

The Board notes that:

- So far, only a limited number of countries have concluded treaties adopting the new Article 7 (and with it the full FSE approach).
- It is normal for model tax treaty innovations to take some time to be adopted in actual treaties.
- A decision for Australia to adopt the FSE approach should not be based on the extent of the current take-up of new Article 7 but rather on whether the FSE approach is a conceptually sound approach that would bring benefits to Australia.
- There is still very limited international experience from jurisdictions that have been administering the FSE approach. At the same time, the experience from administration of the arm's length principle as applied to associated entities, which the FSE approach draws ideas from, may prove useful guidance when considering the administration of the FSE approach.
- There is limited specific OECD guidance on how the FSE approach applies in practice, which may contribute to an initial low take-up of the FSE approach as a new international standard. The lack of guidance may also result in complexities and uncertainties in its application to particular situations.

CHAPTER 5: POTENTIAL ADOPTION OF THE FSE APPROACH IN AUSTRALIA — GENERAL CONSIDERATIONS

5.1 This Chapter will examine several topics that the Board has been asked to examine as per the terms of reference:

- recognition of qualifying intra-entity dealings;
- options for adopting the FSE approach;
- principles to follow in amending tax law to adopt the FSE approach; and
- effects of adopting the FSE approach.

RECOGNISING QUALIFYING INTERNAL DEALINGS

5.2 The terms of reference asked the Board to consider implications in the practical application of the FSE approach and for compliance with relevant methodologies including whether granting Australian tax recognition for particular intra-entity dealings that meet the requirements of the new OECD Article 7 may pose risks to the tax revenue and how those risks could be managed. Internal derivatives and the impacts of exchange rate changes are two areas of qualifying intra-entity dealings that the Board has been asked to examine in particular.

5.3 The Board asked for stakeholders' views on: (a) 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; (b) the circumstances in which a foreign currency gain or loss ought to be recognised under the authorised OECD approach,[11] and (c) 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.

11 The authorised OECD approach (AOA) is the FSE approach.

Views in submissions

5.4 Stakeholders that commented on this topic conveyed the view that generally there are not material differences in practice between the outcomes under the FSE approach and under the single entity approach.[12] They also noted that while internal dealings are not recognised as of themselves giving rise to assessable income or deductible expense under the single entity approach, they can be and are recognised and priced as a practical mechanism for achieving an arm's length attribution of the entity's actual external income and expense to the PE.

5.5 Ernst & Young noted that the FSE 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.

> 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.
>
> Ernst & Young

5.6 Ernst & Young submitted that in the case of derivative trading, 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 (that is, only the net exposure relating to the global position will be hedged). It asserted that, in these circumstances, it is 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 and concluded that the only practical way 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.

5.7 Deloitte submitted that there are generally not material differences in practice between the outcomes under the FSE approach and under the single entity approach as historically adopted by Australia.

> Whilst the single entity approach technically limits the extent to which arm's length prices of internal dealings of a PE can be used to attribute profits to the PE by reference to the entity's actual profits, this technical limitation does not commonly result in a different outcome in practice to that under the AOA's functionally separate entity approach.
>
> Deloitte

12 The single entity approach is broadly the same as the RBA approach.

5.8 Deloitte also submitted that the single entity approach is not a total prohibition on recognition of a PE's internal dealings.

> Such dealings are not recognised as of themselves giving rise to assessable income or deductible expense. However, they can be and are recognised and priced as a mechanism for achieving an arm's length attribution of the entity's actual third party income and expense or profit to the PE.
>
> The need for a pragmatic approach to deal with some situations means that it is not always possible, practicable or reasonable in applying the single entity approach to strictly require the tracing of internal dealings and charges to the entity's third party transactions and actual amounts of its income and expense.
>
> Deloitte

5.9 Deloitte noted that in circumstances in which there is a foreign currency gain or loss from transactions, that actual gain or loss can be attributed to the PE, either by way of tracing or by way of an arm's length allocation of the relevant share of net gains or losses as in the Treasury function of a bank where the PE benefits along with the rest of the entity from the Treasury activities. It further adds that nothing in the FSE approach purports to create a foreign currency gain or loss where none exists.

5.10 Deloitte noted that it does not consider there to be any tax revenue risk in relation to profit attribution to/from Australia from the recognition of internal derivatives, which it argues is consistent with current law.

Board's consideration

5.11 The Board is of the view that while the outcome could be similar in some situations, there are some differences between how the FSE approach would operate and how the current approach operates (although there is uncertainty about the current approach in some situations). Key points to note include:

- For foreign branches of an Australian bank:
  - With respect to the attribution of equity capital to the PE, the FSE approach provides 3 alternative methods and if either the host or the resident country adopts one of those methods, the other would have to adopt the same method. The current approach, as detailed in TR 2005/11, recognises the operation of Australia's thin capitalisation rules, as contained in Division 820 of the ITAA 1997 but those rules do not prescribe how much equity capital should be attributed to the foreign PE nor how that amount should be calculated.
  - With respect to the internal funding, if certain functional and other criteria are met, the current approach allows the interest recorded for an internal

'loan' (or interbranch funds transfers) to be used as a proxy for the amount of actual external interest expense or income for the funds transferred if the amount recorded is priced on arm's length terms. The FSE approach would require a determination of whether the internal 'loan' is a qualifying internal dealing that can be recognised in order to be entitled to an arm's length return.

  – With respect to internal derivatives, the FSE approach would allow their recognition if they met specified thresholds.[13] As discussed in Chapter 3, there is currently insufficient published specific guidance on how internal derivatives can be recognised as a basis for determining allocations of the actual income and expenses of a bank to a PE.

- For Australian branches of a foreign bank:
  – With respect to the attribution of equity capital to the PE, the current approach recognises the operation of Australia's thin capitalisation rules, contained in Division 820 of the ITAA 1997. Adopting the FSE approach would require determining whether the Australian thin capitalisation rules are consistent with the allocation methods permitted under the FSE approach.

  – With respect to the internal funding, the current approach in Part IIIB of the ITAA 1936 allows amounts made available by a foreign bank for use by its Australian branch of the bank which are recorded in the branch's accounts as having been provided to the branch by the bank to be regarded as loans.[14] As discussed above, under the FSE approach, internal funding would need to meet the requirements of an 'internal dealing' justifying an arm's length 'lending' return.

  – With respect to internal derivatives, under Part IIIB internal derivatives related to the management of interest rate risk and foreign currency risk and foreign exchange transactions are treated as if they were real transactions for taxation purposes. For other internal derivatives, as discussed for the foreign branches of Australian banks, the Board considers there is insufficient published specific guidance about how the current approach applies. The FSE approach may allow recognition of internal derivatives that meet specified thresholds.

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13 As discussed at paragraph 36 of the 2010 OECD Report, these thresholds are that (i) the documentation is consistent with the economic substance of the activities taking place in the enterprise as revealed by functional and factual analysis, (ii) the dealing is one which independent enterprises would enter into; and (iii) the dealing does not violate the principles of the authorised OECD approach, for example, transferring risks in a way that separates them from functions.

14 As per section 160ZZZ of the ITAA 1936.

- For financial and non-financial enterprises:
  - The key point to note is that the current approach attributes the entity's actual income and expenditure to the PE whereas under the FSE approach the amount of income and expenditure that can be attributed to a PE is not restricted to the amount of income and expenditure of the entity as a whole.

5.12 In addition to the above key points, there would be some differences depending on which version of the FSE approach would be adopted. The 2008 OECD Commentary on old Article 7 allows the implementation of a limited FSE approach in the sense that the recognition of internal dealings does not extend to internal royalties, internal interest for non-financial institutions or to the provision of services that are merely part of the general management of a company, for which no mark-ups (representing a profit paid to another part of the enterprise) could be charged — these should be allocated on an actual cost basis only. In contrast, the new Article 7 and the corresponding 2010 OECD Commentary does not contain those restrictions to the recognition of qualifying internal dealings or in respect of their pricing.

5.13 It is the Board's view that a key advantage of adopting the FSE approach, of particular relevance to banks, is that it would more explicitly and directly allow the recognition of internal derivatives that meet specified thresholds. This would be an alternative to the additional guidance suggested in Chapter 3 on how the current law operates or to the required specific amendments to the current law that would be needed to ensure that internal dealings could be appropriately recognised as a basis for determining allocations of the actual income and expenses of a bank to a PE.

5.14 Also, to the extent that some of Australia's top two-way trading partners also adopt the use of the FSE approach in practice for the purposes of allocating profit to PEs, adoption of the FSE approach would assist the goal of Australia being a financial centre as it would be consistent with that practice.

5.15 The Board notes, though, that there is limited specific or prescriptive guidance in the OECD report on the attribution of profits to PEs as to how to apply the FSE approach in practice. The report allows for some variability in the operation of the FSE, for example on capital allocation. The report is also not prescriptive on matters such as the debt/equity characterisation or on how to differentiate where an internal dealing simply recognises the performance of a risk management service from when the dealing also involves the recognition of a transfer of the risks being managed, resulting in a materially different arm's length reward.

5.16 There is also very limited guidance on how a qualifying internal dealing could give rise to a foreign currency gain or loss that is relevant to the profit attributable to a PE in a similar way to which a subsidiary would recognise foreign currency gains or losses on analogous cross-border transactions with its parent, or vice-versa. The lack of guidance may result in uncertainties in its application to particular situations.

5.17 The Board nevertheless notes that not taking appropriate account of internal dealings as part of the attribution of profits to a PE has the potential to produce results that would not reflect the significant economic activities of a banking PE (as illustrated in Appendix C).

5.18 On the other hand, it is the Board's view that a potential disadvantage of adopting the FSE approach is that it could impose additional compliance costs and uncertainties for entities in the non-financial sector and for SMEs, linked to the need to substantiate qualifying internal dealings that are conducted on an arm's length basis as opposed to only having to substantiate the allocation of actual external income and expenses to the PE.

Observation 4:

The Board notes that:

- Key advantages of adopting the FSE approach include:
  - Of particular relevance to banks, the FSE approach would more explicitly and directly recognise all internal derivatives that meet specified thresholds. In this regard, not taking account of internal derivatives as part of the attribution of profits to a PE has the potential to produce results that would not reflect the significant economic and commercial activities of a banking PE.
  - To the extent the common commercial practice is consistent with the requirements of the FSE approach, at least in terms of how banks manage risk, the FSE approach has the potential to not impose undue compliance costs on that sector (refer to discussion in Chapter 6).
  - To the extent that some of Australia's top two-way trading partners also adopt the use of the FSE approach in practice for the purposes of allocating profit to PEs, it would assist the goal of Australia being a financial centre as it would be consistent with that practice.
  - The FSE approach more appropriately addresses the relative contribution of PEs where the enterprise makes an overall loss (as illustrated in Appendix C).
- Key disadvantages of adopting the FSE approach include:
  - It could impose additional compliance costs and uncertainties for entities in the non-financial sector and for SMEs (refer to discussion in Chapter 6):
    - : These potential additional compliance costs and uncertainties are related to the need to substantiate qualifying internal dealings that are undertaken on an arm's length basis as opposed to only having to substantiate the allocation of actual external income and expenses to the PE.

  - There is limited specific guidance in the OECD report on the attribution of profits to PEs on how to apply the FSE approach in practice. There is also very limited guidance on how a qualifying internal dealing could give rise to a foreign currency gain or loss that is relevant to the profit attributable to a PE. This lack of guidance may result in uncertainties in its application to particular situations.

- In addition, the tax revenue impact of adopting the FSE approach is not clear (see discussion in Chapter 6), for example as a consequence of:

  - allowing a mark-up for services provided or received;

  - allowing deductions for 'arm's length' royalties for use of a foreign entity's intellectual property;

  - allocating economic ownership of assets as between a PE and other parts of the entity of which the PE is a part; and

  - recognising internal interest charges for non-financial institutions,

  particularly if the law is not amended to ensure symmetrical treatment of notional income and expense amounts for both the foreign PE and the Australian resident entity and also provision is not made for withholding tax on the relevant notional payments.

OPTIONS FOR ADOPTING THE FSE APPROACH

5.19 The terms of reference asked the Board to consider implications for the domestic law and for tax treaty policy of adopting the FSE approach and in particular whether the approach should be adopted: (a) on a treaty by treaty basis and, if so, the implications of having different rules in different treaties (and respective commentaries to follow in applying those rules); or (b) as part of Australia's domestic law for application in all circumstances, subject to conformity with any relevant treaty.

Views in submissions

5.20 Most stakeholders who commented on this topic supported incorporating the FSE approach into Australia's domestic law as opposed to a treaty by treaty approach.

5.21 Ernst & Young supported incorporation of the FSE approach into Australia's domestic law. It noted that the alternative approach of waiting until Australia renegotiates its international treaties 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. Deloitte also said that the FSE approach should be adopted as part of Australia's domestic law, through a revision of the current (draft) Subdivision 815-C.

5.22 The ABA also supports the incorporation of the FSE approach into Australia's domestic law as opposed to a treaty by treaty.

> … implementing the AOA on a treaty by treaty basis is not preferred as it will take a considerable amount of time for treaties to be amended to incorporate the new Article 7, potentially resulting in a disparity of outcomes among treaty partner countries for which Article 7 of the DTA has been amended, treaty partner countries for which Article 7 has not yet been amended and non-treaty countries. This is not an efficient way to adopt OECD best practice and will add significant compliance costs.
>
> ABA

5.23 On the other hand, TTI supports a flexible approach, adopting the FSE approach on a treaty by treaty basis, which would ensure that Australia is not left behind and is free to include or not include new Article 7 in newly negotiated treaties.

> It may be the case that, rather than being able to adopt or reject the new Article 7 on a universal basis into all of Australia's treaties, whether new Article 7 is adopted or not will be determined according to the position held of the particular treaty partner with whom Australia is negotiating/renegotiating its treaty. This will give Australia an approach that is consistent with the particular treaty partner, that would be beneficial in both the negotiation process and afterwards once the treaty is settled.
>
> TTI

Board's consideration

5.24 The Board notes that an advantage of adopting the new Article 7 on a treaty by treaty basis is that it allows the Government to restrict the provisions of the full FSE approach to those jurisdictions that agree to apply those provisions on a reciprocal basis.

5.25 On the other hand, the Board notes that a disadvantage of adopting the new Article 7 on a treaty by treaty basis is, as stakeholders have noted, that it could take a considerable amount of time for treaties to be amended to incorporate the new Article 7, potentially resulting in a diversity of outcomes. These diverse outcomes would comprise:

- treaty partner countries for which Article 7 of the corresponding DTA has been amended (which would broadly reflect the FSE approach);
- treaty partner countries for which Article 7 has not yet been amended (which would reflect the RBA approach as contained in the corresponding treaty); and
- non-treaty countries which would remain unaffected by the FSE adoption in treaties (and which would reflect the RBA approach as contained in domestic law).

5.26 The Board considers that if the FSE approach were to be adopted in Australia, an option which would assist in restricting the diversity of outcomes would be to introduce amendments to domestic law to reflect the more limited FSE approach as per the guidance contained in the 2008 OECD Commentary on old Article 7, which could be supplemented with bilateral negotiations with treaty partners to adopt new Article 7.

5.27 Adopting the FSE approach in full in domestic law would require consideration of the legislation required for a number of significant features of the FSE approach, including the treatment of royalties, rent and interest (for non-financial institutions), the treatment of capital (including whether to amend Australia's thin capitalisation rules) and the allocation of economic ownership of assets as between a PE and other parts of the entity of which the PE is a part.

5.28 A more limited option would be to adopt the FSE approach for financial institutions. This could be done through a modernisation of Part IIIB of the ITAA 1936, which would include its extension to Australian financial institutions and increasing the scope of the provision to cover financial arrangements as defined in Division 230 of the ITAA 1997. This targeted option would also not impose the compliance requirements of the FSE on non-banks and SMEs.

Observation 5:

The Board notes that:

- An advantage of adopting the new Article 7 on a treaty by treaty basis is that it allows the Government to restrict the provisions of the full FSE approach to those jurisdictions that agree to apply those provisions on a reciprocal basis.

- A disadvantage of adopting the new Article 7 on a treaty by treaty basis is that it could take a considerable amount of time for treaties to be amended to incorporate the new Article 7, potentially resulting in a diversity of outcomes, including for non-treaty countries which would remain unaffected by FSE adoption in treaties only.

  – An option which would assist in restricting the diversity of outcomes would be to introduce amendments to the domestic law to reflect the more limited FSE approach (as per the 2008 OECD Commentary), which could be supplemented with bilateral negotiations with treaty partners.

- Adopting the FSE approach in full in domestic law would require consideration of the policy and law design in respect of a number of significant features of the FSE approach, including the treatment of royalties, rent and interest (for non-financial institutions), the treatment of capital (including whether to amend Australia's thin capitalisation rules) and the allocation of economic ownership of assets as between a

PE and other parts of the entity of which the PE is a part.

- A more limited option would be to adopt the FSE approach for financial institutions. This could be done through a modernisation of Part IIIB of the ITAA 1936, which would include its extension to Australian financial institutions and increasing the scope of the provision to cover financial arrangements as defined in Division 230 of the ITAA 1997. This targeted option would also not impose the compliance requirements of the FSE on non-banks and SMEs.

PRINCIPLES TO FOLLOW IN AMENDING THE TAX LAW TO ADOPT THE FSE APPROACH

5.29 The terms of reference asked the Board to advise what principles should be followed in amending the income tax legislation if the Government were to adopt the OECD FSE approach. This advice should cover the implications of adopting the new approach for the special rules dealing with Australian PEs of foreign financial institutions.

Views in submissions

5.30 Some stakeholders who commented on this topic supported giving symmetrical treatment to inbound and outbound activities of multinational corporations.

> … 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).
>
> Ernst & Young

5.31 Other stakeholders noted the need for particular considerations or a more limited adoption of the FSE approach. They noted that any new rules should have regard to the different industry groups and the different circumstances in which a branch can arise for taxation purposes (including PEs arising by virtue of the operation of specialist significant assets) and argued that it is quite possible that different industry groups may not be aligned on a universal branch taxation model.

5.32 Pitcher Partners argued that adoption of the separate entity approach should be:

- on an 'opt-in' basis (by, for example, taxpayers making an irrevocable election to apply a separate entity approach on a country by country basis — that is, to cater for the fact that a number of our trading partners have reserved their position);
- limited to taxpayers in the financial services industry; or
- limited to taxpayers with a turnover above the current Taxation of Financial Arrangements ('TOFA') thresholds.

5.33 Pitcher Partners argued that it would be inappropriate for the adoption of the separate entity approach to be applied on a mandatory basis across all taxpayers as the compliance costs of doing so probably far outweigh any revenue that might be raised and that sufficient testing should be done using real life case study examples on how the separate entity approach will apply in practice.

> In the event that the Board does, however, consider the application of this approach across all taxpayers, we believe it is imperative that sufficient consultation should occur on the practical implications for all taxpayers, especially those in the middle market who will form the majority of taxpayers that will be affected by this measure.
>
> Pitcher Partners

5.34 Some stakeholders noted the need for interim changes to the law while the Government continues to assess the right policy response for Australia.

> … while the Government continues to assess the right policy response for Australia, as an interim solution we recommend that the issues that Australian banks currently face with respect to the recognition of internal financial transactions be addressed via legislation so Australian banks are not disadvantaged in comparison with their international peers and are provided with certainty of tax treatment in this area. The suggested legislative changes should seek to apply the AOA for profit attributions to all bank financial arrangements, including internal loans and derivatives.
>
> ABA

5.35 TTI submitted that in making amendments to the Australian domestic law, should the decision be made to adopt the FSE approach, due regard should be given to the following:

- ensure the adoption of the FSE approach does not give rise to taxable gains or losses where no actual transactions or disposals have taken place;
- ensure the imposition of withholding taxes on internal transactions does not impose an unintended economic cost (such as no credit or offset being available in the home country for any Australian withholding tax); and

- consider any necessary changes to the transfer pricing laws to accommodate the adoption of the FSE approach.

Capital allocation rules

5.36 Some stakeholders submitted that there was no need to change the existing Division 820 thin capitalisation rules in relation to capital attribution to branches if Australia adopts the full FSE approach.

> The ABA considers that adopting the AOA for profit attribution can be consistently applied whilst retaining Australia's current thin capitalisation rules, which apply for the purposes of determining the amount of interest that is deductible for tax purposes.
>
> ABA

5.37 TTI suggested that Australia should adopt a similar approach for the allocation of capital to PEs and subsidiaries and recommended following the OECD guidelines.

Deemed permanent establishments

5.38 TTI made the following points with respect to deemed PEs:

- these type of PEs arise most commonly in the resource services industry where globally mobile assets of significant value are leased into or operated in Australia;
- an issue arises as to whom the tangible asset should be attributed and to whom the risks associated with the operation of the equipment being operated should be attributed;
  - substantial equipment is often leased by its owner on a fixed price or 'no risk' (at least to the lessor) basis (that is, by way of a bareboat lease or dry charter (depending on the industry)) and the lessor derives a fixed and risk-free income stream;
  - the risk associated with the utilisation/performance of the equipment under such passive lease arrangements is then passed to the lessee;
- a deemed PE of this nature does not generally arise in other jurisdictions, nor are equipment lease payments generally regarded as payments of royalties as they are in Australia;
- under a FSE approach, royalty withholding tax could apply to equipment lease payments 'paid' by an Australian PE to its head office. In addition, if the PE has 'borrowed' funds from its head office to acquire the equipment, the question arises whether the interest might also be subject to withholding tax in Australia if FSE treatment is applied to the branch.

5.39 TTI submitted that the FSE approach is not necessarily an appropriate treatment for deemed PEs.

> The FSE approach applies best to permanent establishments with active businesses, but for a variety of reasons (including those discussed above) it is not necessarily an appropriate treatment for deemed permanent establishments (such as one which arises through a lease of (in the case of Australia's tax treaties, substantial) equipment) because of the focus on the 'functions' of the permanent establishment and risks assumed (a deemed permanent establishment does not necessarily have any 'functions' or assume any risks). Where such functions or risks exist in Australia, our view is that both the current and proposed transfer provisions already ensure appropriate Australian tax recognition of those activities.
>
> TTI

5.40 TTI noted that it is difficult to regard a deemed PE as functionally separate from the main entity and to determine this type of PE's tax liabilities under the FSE approach. It submitted that a carve-out may be required to deal with this special type of PE.

Board's consideration

5.41 The Board is of the view that in principle it is preferable to have a consistent regime for the attribution of profits to PEs rather than sectoral regimes and for that regime to be consistent, to the extent possible, with that for dealings between associated entities. A diversity of rules would introduce complexity in the domestic law and potentially higher compliance and administrative costs.

5.42 For similar reasons, the Board would not support an approach where taxpayers could elect the particular regime that would apply to their PE operations on a country by country basis.

5.43 Notwithstanding the above, the Board acknowledges that if the FSE approach were to be adopted through amendments to the tax law, due consideration should be given to the potential impact on the diversity of industries and activities to which the PE attribution rules would apply, including entities engaged in the provision of services to the resources industries through the use of substantial equipment and deemed PEs.

5.44 The Board has received only limited feedback from stakeholders in the non-financial sector that could be affected by the adoption of the FSE approach. The limited feedback has indicated that the FSE approach represents more complexity and higher compliance costs than the current rules, particularly due to the need to undertake functional and factual analysis and establish arm's length pricing on the provision of intra-entity services.

5.45 Any consideration of the adoption of the FSE approach should include, as a key design feature, how it should be applied to entities outside the banking sector in order to minimise adverse compliance and administrative costs. This may involve, for example, the development of administrative guidelines that fit within a consistent legislative framework but cater for simpler or lower value dealings than commonly found in multinational banks.

5.46 The Board is also aware that, apart from general principles, no specific guidance is contained in the 2010 OECD report on the attribution of profits to PEs as to how the FSE approach applies to SMEs. The Board agrees with the view expressed by stakeholders that due consideration should be given to the potential impact on SMEs. In this respect the Board considers that, as a principle, consideration should be given to the development of simplified guidelines for the application of the FSE approach to SMEs, similar to what is currently done for SMEs on the application of the arm's length principle.

5.47 The Board has also been asked to advise on the implications of adopting the FSE approach for the special rules dealing with Australian PEs of foreign financial institutions contained in Part IIIB of the ITAA 1936. As noted at Chapter 10 below, there is broad acceptance of Part IIIB as the primary regime for the taxation of Australian branches of foreign banks. Stakeholders have noted that it is particularly important for foreign banks whose home base is a jurisdiction that does not have a Double Tax Treaty (DTA) with Australia.

5.48 While the Board is in principle not supportive of special or sectoral rules, it acknowledges the special rules in Part IIIB of the ITAA 1936 dealing with Australian PEs of foreign financial institutions that already operate as a carve out of the general PE attribution rules provide certainty for the affected taxpayers.

5.49 Further, the Board agrees with the view that the principles to be applied in calculating the profit attributable to the Australian branch of a foreign financial institution should be the same as the principles to be applied in calculating the profit attributable to an overseas branch of an Australian financial institution (for the purposes of providing relief from any double taxation of income which would occur if Australia were to also tax the amounts that are taxed in the source jurisdiction).

5.50 However, the Board is of the view that Part IIIB should not be repealed unless there is certainty through appropriate guidance or legislation on the application of the tax law to Australian branches of a foreign bank and to overseas branches of an Australian bank.

Observation 6:

The Board notes that:

- As a principle, it is preferable to have a consistent regime for the attribution of profits to PEs rather than sectoral regimes and for that regime to be consistent, to the extent possible, with that for dealings between associated entities.

- Any consideration of the adoption of the FSE approach through amendments to the tax law should include the potential impact on the diversity of industries and activities to which the PE attribution rules would apply, in particular those outside the banking sector (for example entities engaged in the provision of services to the resources industries through the use of substantial equipment and deemed PEs).
  - Any implementation of the FSE approach should include, as a key design feature, how it would be applied to entities outside the banking sector in order to minimise adverse compliance and administrative costs.
- Consideration should also be given to the potential impact on SMEs and the need for the development of simplified guidelines for the application of the FSE approach to SMEs, similar to what is currently done for SMEs in terms of the application of the arm's length principle.
  - This may involve, for example, the development of administrative guidelines that fit within a consistent legislative framework but cater for simpler or lower value dealings than commonly found in multinational banks.
- The principles to be applied in calculating the profit attributable to the Australian branch of a foreign financial institution should be the same as the principles to be applied in calculating the profit attributable to an overseas branch of an Australian financial institution (for the purposes of providing relief from any double taxation of income).
- Part IIIB should not be repealed unless there is certainty through appropriate guidance or legislation on the application of the tax law to Australian branches of a foreign bank and to overseas branches of an Australian bank.

Effects of adopting the FSE approach

5.51 The terms of reference asked the Board to consider, in light of the evidence on the emergence of the FSE approach as a new international standard, the extent to which adoption of the FSE approach would: (a) affect Australian multinational enterprises in carrying on business through offshore branches in key trading and investment destinations; and (b) benefit foreign groups investing into Australia. It also asked the Board to consider implications for granting relief from double tax for Australian multinational enterprises in respect of their income taxable in an offshore branch country under the new Article 7.

Views in submissions

5.52 Most, but not all, stakeholders who commented on this topic considered that there would be very limited impact on taxpayers from adopting the FSE approach, apart from providing increased certainty and greater assurance that double taxation will not ultimately occur.

5.53 Deloitte argued that the impact would be in most cases very limited, if not zero.

> This is because in practice the application of the arm's length principle involves hypothesising the branch as a separate entity, and recognising internal dealings by analogy to attribute profit/loss between the head office and branch. The OECD guidance (2008), TR 2001/11 and TR 2005/11 form the main guidance principles followed in applying the arm's length principle.
>
> The main impacts would be the recognition of internal royalties, clearer recognition of mark-ups for 'routine' services and recognition of internal interest for non-financial institutions. A major benefit of adopting the AOA would be greater clarity of position for companies, reduced uncertainty and complexity and harmony with most major trading partners in the OECD, including for arrangements covered by treaty, greater assurance that double taxation will not ultimately occur.
>
> Deloitte

5.54 Ernst & Young submitted 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. A similar functionally separate entity approach is also generally adopted by non-bank enterprises that operate in foreign jurisdictions through branches.
>
> Ernst & Young

5.55 Ernst & Young further submitted that adopting the FSE approach would ensure the potential risk of double taxation is minimised; eliminate the additional compliance burden associated with maintaining different accounting records (where multinationals operate through branches in jurisdictions that generally accept the authorised approach); and reduce the complexity and resources required with respect to operational transfer pricing matters.

5.56 ABA noted that continuing with the current RBA approach carries the risk of significant double taxation (or less than single taxation) and an increased potential for disputes with Australia's treaty partners, which drains taxpayers and ATO resources. It argued that from a compliance perspective banks will find it extremely difficult, if not impossible, to administer the RBA approach, as it is interpreted by the ATO, with regard to the recognition of internal derivatives.

Board's consideration

5.57 The Board is of the view that impacts of FSE adoption would be different depending on the different types of taxpayers:

- To the extent Australian banks with foreign branches have adopted practices that are consistent with the requirements of the FSE approach, the FSE approach would provide more certainty, particularly with respect to their treatment of internal derivatives, which would outweigh any potential disadvantages related to additional compliance costs.

- For foreign banks with branches in Australia, the FSE approach would extend to arrangements not covered by Part IIIB, but if Part IIIB were repealed, the FSE approach would potentially create more complexity and compliance costs associated with the need to substantiate their qualifying internal dealings.

- For non-financial enterprises and SMEs the FSE approach, as noted above, is likely to represent more complexity and higher compliance costs than the current rules, particularly due to the need to undertake functional and factual analysis and establish arm's length pricing on the provision of intra-entity services.

5.58 Subject to the outcome of the administrative guidance or legislation referred to in Chapter 3, adopting the FSE approach would provide greater likelihood of outcomes consistent with commercial practices with respect to the recognition of internal derivatives in banks, to the extent that the requirements of the FSE approach are consistent with common commercial practice.

Observation 7:

The Board notes that the key effects of adopting the FSE approach would be:

- For Australian banks with foreign branches, to the extent they have adopted practices that are consistent with the requirements of the FSE approach; the FSE approach would provide more certainty, particularly with respect to their treatment of internal derivatives.

- For foreign banks with branches in Australia, the FSE approach would extend to arrangements not covered by Part IIIB, but if Part IIIB were repealed, the FSE approach would potentially create more complexity and compliance costs associated with the need to substantiate their qualifying internal dealings.

- For non-financial enterprises and SMEs, the FSE approach, as noted above, is likely to represent more complexity and higher compliance costs than the current rules, particularly due to the need to undertake functional and factual analysis and establish arm's length pricing on the provision of intra-entity services.

CHAPTER 6: ADMINISTRATION, COMPLIANCE AND REVENUE IMPACTS OF ADOPTING THE FSE APPROACH

6.1 This Chapter will examine the following topics as requested by the terms of reference:

- substantiating qualifying internal dealings;
- worked examples of qualifying internal dealings under the FSE approach;
- compliance implications of adopting the FSE approach; and
- revenue impacts of adopting the FSE approach.

SUBSTANTIATING QUALIFYING INTERNAL DEALINGS

6.2 The terms of reference asked the Board to consider any special requirements for businesses, both in the finance and non-finance sectors, as part of the implications of the practical application of the FSE approach and for compliance with relevant methodologies. The Board was also asked to consider the corresponding implications for the administration of the law, in relation to the functional analysis and evidence required to meet the OECD standard for recognition of their intra-entity dealings.

Views in submissions

6.3 Stakeholders referred to the required functional and factual analysis and the methods used and documentation available to substantiate qualifying intra-entity dealings.

6.4 Ernst & Young noted that the documentation and third party records that would typically be available to the ATO to review 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 and OECD's guidelines, which would include a factual and functional analysis of the enterprise and the relevant PEs;
- agreements and other documentation evidencing comparable third party dealings;
- documents prepared for regulatory and business management purposes;
- financial accounts for the enterprise and its PEs;
- organisational charts showing the people resources located in the relevant jurisdictions; and
- email and other documented records which evidence the negotiations and decision-making process with respect to both third party transactions and qualifying internal dealings.

6.5 Commenting on the methodologies used for pricing internal dealings Ernst & Young noted that the most commonly used methods are:

- for internal funding or loans — the comparable uncontrolled price (CUP) method, using internal records on third party loan data and Bloomberg data for third party debt instruments;
- for internal derivatives and spot foreign currency transactions — the CUP method, using internal trading systems applied to price derivative instruments transacted with third parties;
- for services — the cost plus method, using financial accounts maintained for the relevant parts of the bank and its branches and external comparable data to benchmark the cost plus mark-up; and
- for global trading books — the profit split method, using financial accounts maintained for the relevant parts of the bank and its branches.

6.6 Deloitte submitted that in practice, traders are, in fact, commonly applying the CUP method in pricing dealings with internal desks. It noted that CUPs may be sourced from publicly traded data available on the same day as the internal dealing.

> The traders are responsible for managing the profit and loss in their books. As such, traders are incentivised to price all dealings, including internal dealings, on an arm's length basis. Prices that are too low will reduce the profits of the desk providing the funding/hedging (which often has a direct impact on the performance measurement and compensation of the trader), while prices that are too high will cause the desk seeking the funding/hedging to obtain the funding/hedging externally.
>
> Deloitte

6.7 Deloitte also submitted that the alternative commonly applied method to determine an arm's length reward between a branch (commonly multiple branches) and head office is the profit split, used at different levels of aggregation of book depending on the situation.

6.8 Deloitte submitted that with respect to derivatives, the 'tracing through' approach often does not work as offsetting positions are netted off and then any residual risk is hedged on a portfolio basis. It also submitted that the 'fungibility' approach often does not work as components of an initial trade with a third party may be hedged against different desks (and then aggregated with the positions of each of those desks before being hedged out again on a portfolio basis).

> The difficulty in a 'fungibility' approach then lies in determining both the sum of the third party expense as well as the proportion in which this sum should be divided across the different desks/branches.
>
> Deloitte

6.9 ABA noted that internal derivatives are booked into front office systems that flow into various back office systems (including the general ledger), which provide a robust audit trail for their recognition and pricing irrespective of whether they are with external or internal counterparties.

> Auditable internal pricing models provide a standard market-based approach to pricing. These models are based on market prices for the underlying financial instruments quoted by external market information providers such as Bloomberg and Reuters and provide a basis for valuing all derivative transactions whether for third parties or internal transactions, dealings with subsidiaries or branches. This ensures that all derivative transactions, including internal derivatives are recognised at arm's length market prices. These prices are used to determine the accounting profit of the entity.
>
> ABA

6.10 AFMA noted that the methodology applied to determine the rates and prices charged internally by foreign banks in transactions with their Australian branches mirrored the pricing and rates for transactions with external counterparties.

> For funding transactions, generally the pricing is based on the wholesale rates at which the bank could issue floating rate notes for the particular tenor in question. For derivative transactions, foreign exchange transactions and other internal dealings, such dealings are priced using arm's length market rates. There is a wide range of data service providers (including AFMA) that publish pricing data for the significant OTC markets.
>
> It is noted that the functional currency of the internal dealing will generally have no bearing on the methodology applied to price the dealing.
>
> AFMA

Board’s consideration

6.11 The FSE approach builds, by analogy, on the use of OECD transfer pricing guidelines used in determining arm’s length prices for transactions between associated enterprises, for example between a parent entity and its subsidiary.

6.12 However, the 2010 OECD Report recognises that a PE is not the same as a subsidiary and that ‘… dealings between a PE and the rest of the enterprise of which it is a part have no legal consequences for the enterprise as a whole’ (at page 19). The Report states that ‘… this implies a need for greater scrutiny of dealings between a PE and the rest of the enterprise of which it is a part than of transactions between two associated enterprises. This also implies a greater scrutiny of documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist. The Report observes that considering the uniqueness of this issue, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealing’ (at page 19).

6.13 The Report goes on to note that the FSE approach ‘… is generally not intended to impose more burdensome documentation requirements in connection with intra-enterprise dealings than apply to transactions between associated enterprises’ (at page 20). These ‘… requirements should not be applied in such a way as to impose on taxpayers costs and burdens disproportionate to the circumstances’ (at page 20).

6.14 The Board considers that these comments point to the need for documentation that is appropriate to the particular situation. At the same time, documentation of itself is not sufficient for a dealing to be accepted as a qualifying internal dealing. For example, documentation does not obviate the need for a clear functional and factual analysis to be undertaken. Thus while the documentation must be consistent with, and support, the functional and factual analysis, the analysis itself is important in demonstrating the economic and commercial significance of the relevant dealing, without which recognition would be very difficult if not practically impossible.

6.15 Features of dealing in internal financial instruments, including derivatives, make sound documentation and functional and factual analysis particularly important. The volume of such dealings by banks and the nature of banking business raise particular issues in the banking sector.

6.16 Submissions point out that external market information providers provide a basis for valuing internal financial instrument dealings. In straightforward situations, contemporaneous documentation could be expected to assist in determining an arm’s length price once a dealing was recognised as a qualifying internal dealing. However, the Board has been advised that verifying arm’s length pricing of even third party derivatives is much more difficult post the GFC.

6.17 Factors such as frequently changing prices, collateralisation and other arrangements to address credit risk, and the potential for a complex internal dealing not to have an equivalent comparable external transaction at the right time also means that obtaining an arm's length price may not always be straightforward. This situation would also apply to transactions between different (but associated) legal entities. However, pricing complexities are exacerbated for intra-entity dealings due to the position posited in the 2010 OECD Report that PEs generally have the same creditworthiness as the entity of which they are part.

6.18 The Board understands that the same creditworthiness observation in the 2010 OECD Report is itself subject to increasing question as a result of post-GFC moves in some countries to ring-fence PEs through a process known as 'subsidiarisation'. This process may entail, for example, requiring the assets of PEs to be available to meet the rights of depositors only in the PE's jurisdiction. An adjustment to the price of an external transaction for the purpose of pricing an internal dealing accordingly may be required to reflect effective differences in credit risk of the PE and the rest of the enterprise of which it is a part.

6.19 As noted above, functional and factual analysis is required independent of documentation. Such analysis could assist, for example, in determining whether there is economic and commercial sense in the classification of an internal derivative as part of a hedging relationship and whether the pricing appropriately reflects the functions being undertaken by various parts of the enterprise as part of that relationship.

6.20 The Board is mindful of the need not to impose undue compliance burdens on taxpayers while seeking to ensure that commercial ways of dealing in risk are reflected in the tax rules. At the same time, the Board considers that there would be considerable risks to the tax revenue (particularly given the value of many cross-border financial dealings) if there was an absence of adequate administrative safeguards in terms of documentation and functional and factual analysis.

6.21 In this regard, factors that could be considered to minimise the tax revenue risks include that:

- the parts of the enterprise that are party to the internal dealing are treated and operate (for example, in terms of governance, systems and processes) as independent and separate business units for the purposes of their respective economic and commercial performance;
- if the internal dealing has a hedging purpose, that it meets the requirements of a hedging financial instrument for financial accounting purposes;
- the enterprise prepares a financial report in accordance with appropriate accounting standards and the report is appropriately audited; and
- particularly where the part of the enterprise to which the relevant risk is transferred has a risk management function, it is externally focused, that is its predominant purpose is to deal with third parties.

6.22 The Board notes that a precedent for some of these issues can be found in the elective tax hedging and elective financial reports methods of the 'TOFA' rules in Subdivisions 230-E and F of the ITAA 1997.

6.23 Subdivision 230-E is designed to reduce the extent of mismatches between the tax treatment of certain financial arrangements and the relevant hedged item. The provisions do this by referring to the economic relationship between the hedging financial arrangement and the hedged item, and not solely by referring to the nature of the rights and/or obligations comprising the hedging financial arrangement. This introduces the possibility of after-the-event selectivity of tax treatment that might arise without robust administrative safeguards.

6.24 While the safeguards include a requirement for near contemporaneous documentation, they go further. For example, an appropriately audited financial report prepared in accordance with appropriate accounting standards is required. The hedging of the relevant risk must meet tests of effectiveness, a requirement that in a hedging context is similar to a functional analysis.

6.25 Subdivision 230-F provides for the financial reports method, which allows taxpayers to calculate the gains and losses from financial arrangements by reference to relevant accounting standards. To make and maintain the election to apply this treatment, the taxpayer must meet a number of requirements. They include accounting and auditing requirements along the lines mentioned in relation to tax hedging.

6.26 The taxpayer must also have robust and reliable accounting systems, and appropriate internal governance systems to ensure compliance with accounting and tax obligations. The systems, controls and processes must be reliable for the purpose of preparing the entity's tax return. Such requirements should be considered and relevantly adapted for the purpose of ensuring that the documentation and functional and factual analysis underpinning the FSE approach are mutually reinforcing and provide integrity if the FSE approach is implemented.

6.27 The compliance and administrative issues are further explored below.

Observation 8:

The Board notes the importance of:

- documentation relating to internal dealings, including derivatives, that is:
  - appropriate to the particular situation, enabling greater scrutiny than might otherwise be required for transactions between associated enterprises but generally not requiring such additional documentation that would impose costs and burdens disproportionate to the circumstances;
  - consistent with and that supports the FSE's required functional and factual analysis; and
- functional and factual analysis that demonstrates the economic and commercial significance of the relevant dealing.

Compliance and administrative implications of adopting the FSE approach

6.28 The terms of reference asked the Board to consider whether adopting the FSE approach would bring greater certainty to stakeholders and reduce compliance and administrative costs.

Views in submissions

6.29 Ernst & Young noted that adopting the FSE approach would reduce compliance costs compared to the current Australian approach, as the authorised OECD approach is consistent with common commercial practice and 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. It noted that the current Australian approach requires the attribution of actual third party income and expenses consistent with the arm's length principle and that 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.

6.30 Ernst & Young also anticipates that the administrative costs of the authorised OECD approach would 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. It added that if the authorised OECD approach is not adopted, 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.

6.31 TTI submitted that Australian entities will need to examine their transfer pricing methodologies currently in place and consider whether their current policies are appropriate and consistent or inconsistent with the FSE approach.

6.32 A contrary view was expressed by Pitcher Partners, which submitted that the adoption of a separate entity approach is likely to increase compliance costs for most taxpayers — particularly middle market taxpayers.

> In our view most middle market taxpayers will struggle to find the resources to undertake even the first step (that is a functional analysis) in the two step process set out in the 2010 OECD Model Commentary for determining the profits/losses attributable to a permanent establishment — asking/expecting them to then go on and undertake the second step in the process by pricing all qualifying internal dealings using accepted transfer pricing guidelines is completely unrealistic in light of the resourcing constraints faced by the middle market.
>
> In comparison, the current relevant business activity approach is (relatively) easier to comply with given that it uses the profits actually earned by the enterprises as its starting point. As a result the compliance costs under the relevant business activity approach will usually be cheaper — that is there is no need to look at notional income or expenses from intra-entity dealings as under the functionally separate entity approach.
>
> Pitcher Partners

Board's consideration

6.33 The submissions did not present a uniform perspective on the compliance and administrative implications of the FSE approach.

6.34 As set out above, Ernst and Young stated that the FSE approach is consistent with common commercial practice. To the extent taxpayers have adopted practices that are consistent with the FSE approach; the FSE approach would enhance certainty and would not impose undue compliance burdens on taxpayers, particularly in the financial sector.

6.35 The Board received little feedback from large businesses outside the banking sector. However, consultations indicated that, particularly for PEs of a temporary nature, the compliance costs of the FSE approach could be very high. This appeared to be based on a perception that application of the transfer pricing guidelines under the second step of the FSE approach would be quite onerous for relatively straightforward arrangements involving short-term PEs.

6.36 Submissions on behalf of small to medium sized taxpayers also expressed concerns about the compliance costs attendant upon the FSE approach.

6.37 The Board considers that, to the extent that the requirements of the FSE approach are consistent with common commercial practice, the FSE approach would not impose undue compliance burdens. In other situations, however, the extra scrutiny required in respect of internal dealings as well as the application of the transfer pricing guidelines has the potential, without appropriate tailoring, to impose compliance burdens that are disproportionate to the circumstances.

6.38 The Board does consider that the FSE approach is conceptually better equipped to deal with the ways in which risk is allocated and managed within sophisticated multinational enterprises than more traditional approaches that start with the profits that the whole enterprise earns from the relevant business activity and imposes a limit on the profits that can be attributed to the relevant PE.

6.39 As the examples in Appendix C illustrate, the FSE approach obviates the need to undertake difficult or impossible linking of internal dealings to third party income and expenses. Also, the FSE can be seen from those examples to better measure the economic activity in Australia and in other jurisdictions when the enterprise of which the PE is a part makes an overall loss.

6.40 That said, the tax recognition of internal dealings under the FSE approach is not without its difficulties in relation to determining the 'arm's length' reward for qualifying internal dealings that meet the threshold requirements under functional and factual analysis. Administration of the FSE approach is unlikely to be straightforward, particularly in the context of very complex, high value and sophisticated cross border internal dealings. An example in Appendix C also illustrates this point. Should the FSE approach be implemented, fully or in part, robust administrative safeguards would be an important design feature.

6.41 The Board acknowledges that the recognition of internal financial instruments in particular raises a number of complex issues, with attendant difficulties in, and costs of, administering the FSE approach. These difficulties could, however, be ameliorated by appropriate administrative safeguards relating to documentation of internal dealings and processes as well as the undertaking of appropriate functional and factual analysis.

Observation 9:

The Board notes that:

- A major issue for Australian banks is the uncertainty as to whether and, if so, how internal derivatives are to be taken into account in PE profit attribution. To the extent the Australian banks have adopted practices that are consistent with the requirements of the FSE approach; the FSE approach would enhance certainty for this group of taxpayers.

- To the extent that the requirements of the FSE approach are consistent with common commercial practice, the FSE approach would not impose undue compliance burdens.
- In other situations, however, the extra scrutiny required in respect of internal dealings as well as the application of the transfer pricing guidelines has the potential, without appropriate tailoring, to impose compliance burdens that are disproportionate to the circumstances. Concerns have been expressed in this regard on behalf of enterprises with short-term PEs and on behalf of small to medium sized taxpayers.
- The recognition of internal financial instruments in particular raises a number of complex issues, with attendant difficulties in, and costs of, administering the FSE approach. These difficulties could, however, be ameliorated by appropriate administrative safeguards relating to documentation of internal dealings and processes as well as the undertaking of appropriate functional and factual analysis.
- The tax recognition of internal dealings under the FSE approach is not without its difficulties in relation to determining the 'arm's length' reward for qualifying internal dealings that meet the threshold requirements under functional and factual analysis. Administration of the FSE approach is unlikely to be straightforward, particularly in the context of very complex, high value and sophisticated cross border internal dealings. Should the FSE approach be implemented, fully or in part, robust administrative safeguards would be an important design feature.

WORKED EXAMPLES OF QUALIFYING INTERNAL DEALINGS

6.42 The terms of reference noted that the Board's report could usefully include worked examples of how a range of intra-entity dealings in financial arrangements commonly undertaken by financial entities (such as internal loans, internal derivatives and foreign exchange arrangements) would be treated for tax purposes under the FSE approach.

Views in submissions

6.43 No detailed feedback has been received on this topic as raised in the Board's discussion paper. In its submission in response to the discussion paper, ABA referred to earlier consultations with the Board where it had provided details as to how inter-branch derivatives operate.

Board's consideration

6.44 Examples and corresponding commentary are contained in Appendix C. The main points made in that Appendix are reproduced in the following Observation by the Board.

Observation 10:

The Board notes that:

- The FSE approach is conceptually apposite to the task of attributing profits to PEs that are separate and independent parts of an enterprise. In contrast with the RBA approach, the FSE approach works appropriately both when the enterprise makes an overall profit as well as when it makes an overall loss. The process by which the FSE attribution is done is simpler and more straightforward.

- The FSE approach conforms much better than the RBA approach to the way in which risk is allocated in a sophisticated banking setting. The traditional approach of allocating actual income and expenditure raises difficult questions when applied to complex portfolio management of risk.

Revenue Impacts

6.45 The terms of reference asked the Board to consider short-term and long-term impacts on taxation revenue of possible options in the context of the Government's fiscal position and strategy.

Views in submissions

6.46 Stakeholders that commented on this topic asserted that they did not envisage that Australia's adoption of the authorised OECD approach and the new Article 7 would produce any significant changes to Australia's tax revenue.

6.47 ABA noted that a move to adopt the FSE approach to attributing profits to PEs is not expected to have a material adverse tax revenue impact; however, it would provide greater certainty for taxpayers. It also asserted that in the case of Australian headquartered banks providing outbound services to their foreign branches, adoption of the FSE approach may be revenue accretive as it would allow for a mark-up to apply to the allocation of costs for general management and administrative intra-entity services.

6.48 Ernst & Young submitted that it did not envisage Australia adopting the authorised OECD approach and the new Article 7 would produce any significant changes to Australian tax revenue and neither does it expect that the use of the FSE approach, as compared to the 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.

Board's consideration

6.49 Submissions did not provide detailed data, information or analysis that could form the basis for estimating the tax revenue effects of adopting the FSE approach.

6.50 To the extent that adoption of the FSE approach would merely provide legislative support for current practices consistent with tax administration, it could be argued that there would be no impact on the tax revenue. However, it is very unlikely that such a conclusion could be arrived at without qualification.

6.51 On behalf of Australian banks, ABA does indicate that any tax revenue effect is likely to be slightly positive, that is insofar as the FSE approach would allow a mark-up for services provided by the Australian head office to offshore PEs. This outcome appears to be predicated on the tax law being amended to provide for treatment that is symmetrical to the deduction that would be allowed to the foreign PE under the FSE approach for such a mark-up, namely the taxing of the mark-up in the Australian head office (symmetrical treatment).

6.52 On the other hand, a mark-up on services provided by non-resident entities to their Australian PEs would likely lead to a tax revenue negative outcome under the FSE approach.

6.53 In general, the net tax revenue impact would depend on the effect of the FSE approach on the aggregate balance of functions, assets and risks in respect of dealings between non-resident entities and their Australian PEs. This would be affected by the extent of any symmetrical treatment of Australian resident entities (see further discussion on potential symmetrical treatment of Australian resident entities at Chapter 8).

6.54 The Board notes that the United Nations Committee on International Cooperation in Tax Matters rejected the FSE approach in its Model Double Taxation Convention between Developed and Developing Countries. The reason given for this is that the FSE approach is in direct conflict with the United Nations Model Convention which generally disallows deductions for amounts 'paid' (other than toward reimbursement of actual expenses) by a PE to its head office.

6.55 While not explicit on whether the tax revenue implications were important in the United Nations Model Convention, it is to be noted that adoption of the FSE approach would adversely affect, all other things being equal, the tax revenue of countries who experience the payment of amounts by PEs in their countries to other foreign parts of the entity of which the PEs are a part that are not offset by increased taxation on other amounts received from those other foreign parts.

6.56 The Board understands that the ATO has recently started collecting information about internal dealings from corporate tax returns (item 18d of the International Dealing Schedule). This information may provide a starting point for estimating the revenue impact of the FSE approach, at least in relation to the dealings recorded therein.

6.57 The Board's discussion paper noted that an entity (Australian resident or not) that is a 'registered Offshore Banking Unit (OBU)' that carries on qualifying 'Offshore Banking Activities (OB activities)' at or through its Australian branch operations is taxed at a concessional effective rate of 10 per cent on those activities.

6.58 In considering potential revenue effects of FSE adoption, it would be important to ensure that no tax arbitrage opportunities arise between the concessional OBU rate of 10 per cent and the Australian corporate tax rate of 30 per cent or the applicable overseas tax rate, for example UK income tax rate of 20 per cent.

Observation 11:

The Board notes that:

- To the extent that adoption of the FSE approach would merely provide legislative support for current practices consistent with tax administration, it could be argued that there would be no impact on the tax revenue. However, it is very unlikely that such a conclusion could be arrived at without qualification.
- In general, the net tax revenue impact would depend on the effect of the FSE adoption on the aggregate balance of functions, assets and risks in respect of dealings between non-resident entities and their Australian PEs. This would be affected by the extent of any amendment to the tax law to treat Australian head offices symmetrically to the treatment of the PEs and is also related to the potential imposition of withholding taxes on notional amounts.
  - A mark-up on services provided by non-resident entities to their Australian PEs would likely lead to a tax revenue negative outcome under the FSE approach.
  - A mark-up on services provided by resident entities to their offshore PEs would likely lead to a tax revenue positive outcome if the law ensured symmetrical treatment for both the PE and the Australian resident entity.
  - The ability of non-resident entities to deduct 'arm's length' royalties for use of their intellectual property in their Australian PE operations would likely lead to a tax revenue negative outcome under the FSE approach.
  - The ability to tax resident entities on 'arm's length' royalties for use of their intellectual property in their overseas PE operations would likely lead to a tax revenue positive outcome, if the law ensured symmetrical treatment for both the

PE and the Australian resident entity.

– The ability to impose withholding taxes on notional amounts would likely lead to a tax revenue positive outcome.

CHAPTER 7: SECTORAL CONSIDERATIONS: INSURANCE

7.1 The discussion paper noted that at present, Australia excludes the taxation of insurance enterprises from the general principles of the business profits article in tax treaties and preserves the domestic law for taxing foreign insurers. The Board sought comments from stakeholders on whether Australia should apply the authorised OECD approach to insurers, having regard to the existing tax treatment of insurers, including foreign insurers.

Views in submissions

7.2 Stakeholders who commented on this topic asserted that non-resident insurers or reinsurers should be taxed on profits calculated in accordance with the established OECD principles, as it would assist in getting a more consistent application for insurance/reinsurance enterprises which operate in several jurisdictions and also in addressing the risk of potential double taxation.

7.3 Deloitte submitted that under the FSE approach, it is particularly important in attributing profits to the PE of an insurance enterprise to identify, through a functional and factual analysis, the key entrepreneurial risk-taking (KERT) functions of the business.

> In our view, the proper application of these principles should lead to an appropriate arm's length allocation of profits to PEs involved in the operation of an Australian insurance business.
>
> Deloitte

7.4 Other stakeholders noted that the adoption of the FSE approach in other jurisdictions has resulted in an initial increase in compliance and administrative costs, as well as an increase in uncertainty, as a result of the various tax authorities being at different stages of adoption and familiarity with the FSE approach. However, this was considered to be an inevitable transitional phase with the expectation that the consistency arising from an international consensus should ultimately provide greater certainty in the majority of jurisdictions in which insurance companies operate.

7.5 It was further noted that one of the key reasons for the uncertainty implicit in the adoption of the FSE approach by a number of tax authorities is the lack of clarity in respect of the characterisation (for tax purposes) of the allocation of costs/income and associated internal dealings between branches. It was submitted that in the insurance sector, clear guidance on the accepted character of investment yield allocated between branches would reduce uncertainty and inconsistency of treatment and similarly, clear guidance on the withholding tax consequences (if any) of internal dealings would be critical.

Board's consideration

7.6 The Board acknowledges that bringing the taxation of insurance enterprises under the general principles of the business profits article in Australia's tax treaties and adopting the FSE approach would assist in getting a more consistent application for insurance/reinsurance enterprises which operate in several jurisdictions and also in addressing the risk of potential double taxation.

7.7 However, the Board understands that there is some recognition internationally that insurance is an industry where it is easier to avoid the existence of a PE than other industries. Paragraph 39 of the 2010 OECD Commentary on Article 5 recognises the possibility that insurance companies could conduct large scale business in a State without being taxed by that State on their profits arising from such business.

7.8 The Board understands that such concerns underpin Australia's reservation on Article 7 of the OECD Model (and its implementation in Australia's treaties), which seeks to preserve Australia's ability to tax insurance profits exclusively under domestic law. Division 15 of Part III of the ITAA 1936 seeks to ensure that Australia can tax the 'location specific' rents associated with profits derived from insuring (including reinsuring) local property, businesses or events, without the need for a PE. It does so by taxing non-resident insurers and reinsurers in respect of insured property situated in Australia or where the insured event is one which can only happen in Australia. A taxable income equal to 10 per cent of the premiums paid is deemed to have been derived by the non-resident insurers as a proxy for the underwriting result.

7.9 In conjunction with Australian treaty practice, Division 15 broadens Australia's taxing rights over insurance profits beyond those otherwise permitted by the OECD Model. Amending the current rules to bring the taxation of insurance profits within the scope of the business profits articles in Australia's tax treaties would potentially result in unquantifiable risks to the tax revenue, by limiting Australia's existing ability to tax insurance profits.

7.10 The Board is of the view that at this stage the advantages of bringing the taxation of insurance enterprises under the general principles of the business profits article in Australia's tax treaties and out of the ambit of Division 15 do not outweigh the potential risks to the tax revenue.

Observation 12:

The Board notes that:

- Bringing the taxation of insurance enterprises under the general principles of the business profits article in Australia's tax treaties and adopting the FSE approach:
  - would assist in getting a more consistent application for insurance/reinsurance enterprises which operate in several jurisdictions and also in addressing the risk of potential double taxation, but
  - would have a potential unquantifiable cost to the tax revenue.
- It is the Board's view that, at this stage, the advantages of bringing the taxation of insurance enterprises under the general principles of the business profits article in Australia's tax treaties do not outweigh the potential risks to the tax revenue.

CHAPTER 8: POTENTIAL RECONSIDERATION OF TAX SETTINGS (BEYOND FSE REQUIREMENTS)

8.1 The Board's discussion paper noted that if the authorised OECD approach is adopted in Australia, a question arises whether changes to implement it should be restricted to the determination of the profits that are attributable to a PE for the purposes of Article 7 and Article 23 of a tax treaty. It noted that the 2010 OECD Report and the 2010 OECD Model Commentary on Article 7 do not dictate the application of the authorised OECD approach except in relation to those relevant articles of the OECD model convention.

8.2 Acknowledging the above, the discussion paper asked for stakeholders' views on whether specific rules should be introduced that use the ideas underlying the authorised OECD approach to determine other issues of tax law.

8.3 The discussion paper noted that because of the way in which Australia's network of DTAs operates with the Australian domestic law, applying the FSE approach would not necessarily lead to an entirely complementary calculation of the amount of income taxed in the foreign jurisdiction compared with the amount that might be exempt from taxation in Australia. What is needed to achieve complementarity is to ensure that the final taxable income reflects the net amount that might be exempt from taxation in Australia.

8.4 If the amount that might be exempt from taxation in Australia is affected by amounts of notional expenses of a foreign PE, then symmetric treatment could be given to those amounts as they affect the taxable income of the Australian resident entity.

8.5 Against the above background, the discussion paper raised the possibility that specific adjustments be made to Australian tax law 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.

8.6 Alternatively, it was suggested that it might be preferable to require the Australian resident entity to calculate the assessable income and allowable deductions of its Australian operations separately, and for that purpose to treat all recognised dealings between the Australian resident and its foreign PE, to the extent possible, similarly to transactions with a foreign associate.

8.7 The discussion paper also noted that similar questions arise as to the approach to be adopted in the converse case where a foreign resident enterprise has a PE in Australia.

Views in submissions

8.8 A number of stakeholders submitted that the authorised OECD approach should only apply for the purposes of determining the profits that are attributable to a PE for the purposes of Article 7 and Article 23 of a tax treaty.

8.9 Ernst & Young submitted that the principles contained in the authorised OECD approach should only be applied:

- in calculating the taxable income of the Australian bank branch that is subject to Australian income tax, including the application of the rules in Division 230 of the ITAA 1997, and would not be applied for any other purposes, for example, withholding taxes; and
- 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 (concerning foreign tax offsets) as necessary to prevent double taxation. It also submitted that the principles would not be applied for any other purposes, for example, withholding taxes.

8.10 ABA made a similar submission regarding the potential extension of the ideas underlying the authorised OECD approach to determine other issues of tax law.

> The ABA is of the view that the application of the AOA for recognising inter-branch dealings should be limited to determining the correct allocation of profit to the PE. Such dealings should therefore only be recognised for corporate tax provisions within the tax law relating to the determination of such profits (for example TOFA). It should not be recognised for other corporate and indirect tax purposes of the law (for example interest withholding tax).
>
> ABA

8.11 ABA further submitted that any such treatment would detract from Australia's stated policy objective of becoming a financial services centre in Asia by putting it at a competitive disadvantage to other financial centres that do not impose withholding tax on similar dealings, for example Singapore and Hong Kong.

8.12 As noted at paragraph 5.26, TTI submitted that due regard should be given to ensure the adoption of the FSE approach does not give rise to taxable gains or losses where no actual transactions or disposals have taken place. It also submitted that the FSE approach should not give rise to withholding taxes (for example royalty and interest withholding tax) on internal transactions, for example lease charges or interest.

Board's consideration

8.13 The Board understands the concerns expressed by stakeholders that if Australia were to adopt the FSE approach and use the ideas underlying the FSE approach to determine other issues of tax law, such as imposing withholding taxes on internal transactions, and other jurisdictions do not impose those taxes, there could be a potential to undermine Australia's competitiveness.

8.14 The Board is of the view that if the FSE approach is adopted, further changes should be made to the law to ensure that for any amount that might be exempt from taxation in Australia resulting from notional expenses of a foreign PE, symmetrical tax treatment is given to those amounts as they affect the taxable income of the Australian resident entity. As noted in Chapter 6, this would contribute to a positive tax revenue outcome if the FSE approach were adopted.

8.15 Consideration could also be given in this context to ensuring that the relief against double taxation in Australia resulting from notional income of a foreign PE only operates in respect of comparably taxed jurisdictions. This would assist not only in ensuring appropriate relief is provided from double taxation but also that there is not less than single taxation.

8.16 In order not to undermine Australia's competitiveness, other further amendments to Australian tax law following any adoption of the FSE approach, such as the imposition of withholding taxes on notional amounts, should only be implemented after due consideration is given to the effects on foreign investment in Australia.

Observation 13:

The Board notes that:

- If the FSE approach is adopted, further changes should be made to the law to ensure that for any amount that might be exempt from taxation in Australia resulting from notional expenses of a foreign PE, symmetrical tax treatment is given to those amounts as they affect the taxable income of the Australian resident entity. As noted in Chapter 6, this would contribute to a positive tax revenue outcome if the FSE approach were adopted.
- Consideration could also be given in this context to ensuring that the relief against double taxation in Australia resulting from notional income of a foreign PE only operates in respect of comparably taxed jurisdictions. This would assist not only in ensuring appropriate relief is provided from double taxation but also that there is not less than single taxation.
- Other amendments to Australian tax law following any adoption of the FSE approach, such as the imposition of withholding taxes on notional amounts, should only be implemented after due consideration is given to the effects on foreign investment in Australia.

CHAPTER 9: CONCLUDING OBSERVATIONS ON FSE ADOPTION

9.1 As noted at paragraph 1.10, the Board has been asked to examine and report on the advantages and disadvantages of Australia adopting the FSE approach to the determination of the profits attributable to a PE in its tax treaty negotiations and in the domestic law.

9.2 The previous chapters provided the Board's views on the advantages and disadvantages of Australia adopting the FSE approach, taking into account specific points requested by the terms of reference. This chapter puts forward some concluding observations on FSE adoption.

Board's consideration

9.3 The Board considers that the FSE approach takes a more direct approach to dealing with the ways in which risk is allocated and managed within sophisticated multinational enterprises, such as banks, than more traditional approaches that start with the profits that the whole enterprise earns from the relevant business activity and imposes a limit on the profits that can be attributed to the relevant PE.

9.4 As the examples in Appendix C illustrate, the FSE approach obviates the need to undertake difficult or impossible linking of internal dealings to third party income and expenses. Also, the FSE can be seen from those examples to better measure, at least conceptually, the economic activity in Australia and in other jurisdictions when the enterprise of which the PE is a part makes an overall loss.

9.5 The examples do nevertheless also illustrate that, at a practical level, under Australian tax law the differences between the RBA approach and the FSE approach may often be minimal, even when there is an overall loss. This is due in part to the fact that the Australian RBA approach is to allocate (gross) income and costs/expenses rather than (net) profit.

9.6 It should be noted that the tax recognition of internal dealings under the FSE is not without its administrative difficulties. An example in Appendix C also illustrates this point. Should the FSE be implemented, fully or in part, robust administrative safeguards would be an important design feature.

9.7 Finally, the Board observes that the economic and financial environment in which multinational enterprises operate has been changing, and continues to change rapidly. Since the OECD's work started on the FSE approach, relevant conditions have continued to evolve. This has implications for the design of any changes to implement the FSE; it would need to cater for ongoing change.

Observation 14:

The Board notes that:

- The FSE approach takes a more direct approach to dealing with the ways in which risk is allocated and managed within sophisticated multinational enterprises, such as banks, than more traditional approaches that start with the profits that the whole enterprise earns from the relevant business activity and imposes a limit on the profits that can be attributed to the relevant PE.

- The economic and financial environment in which multinational enterprises operate has been changing, and continues to change rapidly. This has implications for the design of any changes to implement the FSE approach; it would need to cater for ongoing change.

CHAPTER 10: PART III B, THE LIBOR CAP AND THE FSE APPROACH

10.1 The terms of reference asked the Board to advise on the continued appropriateness of having a safe harbour for the interest rate that may be charged for the use of internal funds by foreign banks in their Australian branches, as a proxy for arm's length interest rates, and if so the suitability of the LIBOR cap for that role. This advice should take account of, among other things, the impact of any change to the cap on banking competition and on tax revenue.

10.2 As the provisions on the LIBOR cap are part of the special rules for PEs of foreign financial institutions contained in Part IIIB of the ITAA 1936, the discussion of the LIBOR cap in this chapter is undertaken in the context of those special rules.

10.3 The discussion paper sought comments from stakeholders on whether Part IIIB is consistent with the requirements of the FSE approach and, if not, whether it should be amended to facilitate adoption of the FSE approach. It also asked that if Part IIIB was retained, whether there should be a cap on the interest rate that can be charged on notional debt, and in that case, whether LIBOR or other international benchmark rate would be the most appropriate. It also asked what would be the expected impact on banking competition and on tax revenue if the LIBOR cap were removed.

Views in submissions

Part IIIB

10.4 AFMA supports the retention of Part IIIB as the primary regime for the taxation of Australian branches of foreign banks. It noted that it is particularly important for foreign banks whose home base is a jurisdiction that does not have a DTA with Australia.

> By enshrining a functionally separate entity approach to funding transactions, derivative transactions and foreign exchange transactions, Part IIIB is drafted in a manner consistent with the authorised OECD approach, and particularly the KERT. Part IIIB will recognise the key risks undertaken by the Australian branch of the foreign bank and the passing of the management of the risk to head office through respecting transactions between the branch and head office. However, as noted above, Part IIIB will need to be modernised to ensure that derivative transactions that manage a broad range of risks are eligible for Part IIIB, as opposed to just interest rate risk and foreign exchange risk.
>
> AFMA

10.5 Ernst & Young submitted that the principles 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.

Free capital requirements under the FSE

10.6 AFMA submitted that to the extent that Part IIIB was to properly reflect the authorised OECD approach, an arm's length allocation of capital would be required.

10.7 AFMA argued Division 820 of the 1997 Act represents a comprehensive regime to allocate debt and equity for tax purposes and, accordingly, determine the interest expense that is deductible.

> To the extent that the Australian branch of a foreign bank determines its minimum capital amount with reference to Subdivision 820-E of the 1997 Act, then the capital amount so determined should be treated as arm's length capital under Part IIIB. This will ensure competitive neutrality between inward and outward financial institutions to the extent that the existing requirements under Division 820 are consistent.
>
> AFMA

The LIBOR cap

10.8 Ernst & Young submitted 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 apply or not to apply. It argued that the use of a cap may not produce an arm's length outcome and therefore poses a potential risk of double taxation.

10.9 Deloitte submitted that the LIBOR cap is not reflective of an arm's length outcome in relation to the cost of debt. It is quoted on a 12-month basis as a maximum, does not reflect the significant increase in the cost of wholesale funding since the 2007/8 financial crisis and applies a 'one size fits all' approach to banking.

10.10 Deloitte argued that the arm's length principle provides a better framework to determine deductible debt in Australia.

> Given the difficulties with the Libor cap, in our view, the arm's length principle (in conjunction with the existing thin capitalisation provisions) provides a better framework to determine deductible debt in Australia. This could potentially be applied within the Part IIIB regime as an alternative to the Libor cap, where the arm's length rate exceeds the Libor cap.
>
> Deloitte

10.11 AFMA does not believe that there is any deficiency in the design or operation of the transfer pricing rules that warrants maintenance of either the LIBOR cap or any other benchmark cap on deductibility of interest.

> It is AFMA's contention that any approach that arbitrarily imposes an artificial ceiling on what is deemed to be an arm's length rate is deficient from a policy perspective. Ultimately a bank will satisfy its funding requirements through the issuance of securities with different maturities, currencies and terms in both the short term and long term markets, and the overall cost of funds will fluctuate significantly from one period to the next, let alone from one institution to the next. Accordingly, any tax provision that seeks to generalise the deductibility of interest based on a singular benchmark will be inherently flawed.
>
> AFMA

10.12 AFMA further submitted that the foreign banks most affected by the LIBOR cap may opt out of Part IIIB to avoid the cap if they are headquartered in a jurisdiction that has a DTA with Australia. However, this comes at a cost of greater tax uncertainty from a transfer pricing perspective and the inability to manage the tax affairs of a group in Australia on a collective basis (such as thin capitalisation grouping and the ability to transfer revenue and capital losses to other group entities).

Revenue outcomes

10.13 Based on information received from its members, AFMA submitted that the removal of the LIBOR cap would result in an increase to tax revenue (estimated at more than $15.7 million per annum). AFMA argues that it is expected that the removal of the LIBOR cap would increase the levels of activity conducted by foreign banks at or through Australian branches and accordingly increase the revenue available to be taxed in Australia.

Banking competition

10.14 AFMA submitted that the LIBOR cap has the effect of reducing bank competition.

> … it increases the funding costs for many foreign bank branches, presents a barrier to the free-flow of bank funds and hinders their ability to compete in the business loan market. Some banks have modelled the impact of the LIBOR Cap and report that it has a greater detrimental impact on them than does interest withholding tax on intra-bank funding. A majority of foreign bank branches who are affected by the LIBOR Cap have indicated that their bank would be in a position to increase lending in Australia if the cap was removed.
>
> AFMA

10.15 AFMA further submitted that given the shifting pattern in the geographical source of foreign funding for Australian business through foreign bank branches, new entrants into the Australian banking market are likely to be disproportionately affected by the LIBOR cap because they do not have established independent funding programs in the early stages and are more reliant on parent bank funding to which the cap applies.

Board's consideration

10.16 The Board notes that there is wide industry acceptance of Part IIIB as the primary regime for the taxation of Australian branches of foreign banks. Stakeholders have noted that it is particularly important for foreign banks whose home base is a jurisdiction that does not have a DTA with Australia.

10.17 The Board notes that there are some similarities between the provisions of Part IIIB and the FSE approach. However, Part IIIB adopts a 'separate entity' approach in specific instances only.

10.18 Under Part IIIB the Australian branch and the foreign bank are treated as if they were separate entities in the specific instances set out in the provisions. Certain internally recorded loans, derivatives and foreign exchange transactions are treated as if they were real transactions for taxation purposes.

10.19 However, there are key differences between the provisions of Part IIIB and the FSE approach.

10.20 Under Part IIIB only derivative products related to the management of interest rate risk and foreign currency risk are recognised as real transactions for taxation purposes. Under the FSE, a wider range of internal dealings could be recognised, but a factual and functional analysis needs to be undertaken.

10.21 In relation to notional internal 'loans', Part IIIB provides that the records of the foreign bank determine the interest payable under the loan for the period fixed by the bank and that the amount deductible by the bank cannot exceed the amount that it would be payable if the LIBOR cap were the relevant interest rate.

10.22 The LIBOR cap, together with the other specific provisions in Part IIIB, operates to restrict the amount of interest deductions (in addition to the adjustments for regulatory capital in accordance with Division 820 of the ITAA 1997) to amounts calculated using short term rates.

10.23 In contrast, the FSE approach requires the relevant functional circumstances in which the funds are made available to the bank's Australian branch operations to be examined for the purposes of determining whether there is a qualifying internal dealing, the nature of that internal dealing, and the appropriate arm's length reward for that dealing.

10.24 For example, under the FSE approach, it would be necessary to determine first whether the foreign bank's funding of its Australian branch is provided as a conduit, with a service fee and the external interest cost allocated to the PE, or as a qualifying internal 'loan', with the interest rate charged being in accordance with the arm's length principle.

10.25 The Board acknowledges that the LIBOR cap was introduced as an easily administered method of determining the foreign bank's actual interest costs for funds made available in the bank's Australian branch operations, where the bank could not reasonably determine what its actual interest cost for those funds was. The Explanatory Memorandum (in the introduction of Chapter 11) for the *Taxation Laws Amendment Act (No 3) 1994* noted:

> … funding provided by the foreign bank to its Australian branch will generally be provided from the bank's pool of funds which has been formed by the aggregation of deposits and other funds. The pool of funds is used, amongst other things, by a bank to provide loans to customers. It will be generally difficult for the bank to know the precise cost of funds provided to the Australian branch because the foreign bank's pool of funds will have many sources with different costs. Further, the use of an average cost of funds mechanism is seen as being costly, inaccurate and time consuming.

10.26 As stated in the terms of reference, the Johnson Report noted that in periods of financial stress there can be appreciable differences between LIBOR and commercial rates for inter-bank lending and recommended the removal of the limitation and reliance on the usual transfer pricing rules to determine the amount of the deemed interest deduction.

10.27 The Board further notes that as a result of widely reported manipulations of LIBOR, its status as an international reliable benchmark of the average short term bank to bank borrowing costs was compromised. However, the Board also acknowledges that following the recommendations of the final report of the Wheatley Review of LIBOR,[15] the UK authorities have committed to restoring the confidence of financial markets in LIBOR as an international benchmark.

10.28 In considering whether the LIBOR cap should be removed (or substituted by another cap), the Board has been asked to take account of, among other things, the impact of any change to the cap on banking competition and on tax revenue.

10.29 The Board agrees that the LIBOR cap has the potential to reduce bank competition. Put another way, it is hard to see how a cap on the amount of deductions that can be claimed in respect of intra-entity debt can assist in promoting banking competition by foreign banks with their domestic counterparts that do not face that restriction.

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15 http://cdn.hm-treasury.gov.uk/wheatley_review_libor_finalreport_280912.pdf.

10.30 The LIBOR cap has the effect of potentially increasing the funding costs for foreign bank branches and hinders their ability to compete in the business loan market. Moreover, new entrants into the Australian banking market are likely to be disproportionately affected by the LIBOR cap because they are relatively more reliant on head office funding to which the cap applies.

10.31 The Board acknowledges that the LIBOR cap operates as a safe harbour and that foreign banks with branches in Australia have the option to opt out from Part IIIB. However, opting out from Part IIIB would come at a cost of greater tax uncertainty for those foreign banks that are headquartered in a jurisdiction that does not have a DTA with Australia and, for all foreign banks that opt out of Part IIIB, in the inability to manage the tax affairs of a group in Australia on a collective basis.

10.32 With respect to the potential tax revenue effects, the Board notes the claim by stakeholders that the removal of the LIBOR cap would result in an increase to tax revenue resulting from an increase in the levels of activity conducted by foreign banks at or through Australian branches that would more than outweigh the potential tax revenue loss that would result from allowing the deduction of an arm's length rate in excess of the LIBOR cap.

10.33 The Board has not undertaken a simulation of the net tax revenue effects that would result from the removal of the LBOR cap.

10.34 The Board acknowledges that if the FSE approach were adopted, it would be appropriate to allow foreign banks to use an arm's length interest rate to determine the deductible cost for the use of internal funds provided to their Australian branches. However, as discussed at Chapter 5, internal funding would need to meet first the requirements of an 'internal dealing' in order to justify an arm's length return.

10.35 The removal of the LIBOR cap would be appropriate in the context of adoption of the FSE approach but not as an isolated amendment to Part IIIB. As noted above, in the context of Part IIIB, it fulfils the role of an easily administered method of determining the foreign bank's actual interest costs for funds made available in the bank's Australian branch operations rather than being a proxy for an arm's length return on those funds.

10.36 Moreover, to the extent that the practical application of transfer pricing guidelines allows some flexibility in determining an arm's length price, if the LIBOR cap were removed, the propensity will be to employ an interest rate that is most favourable to the taxpayer with some concomitant cost to the revenue.

10.37 The Board recommends that, subject to confirmation that the removal of the LIBOR cap would result in no material cost to tax revenue, the cap should be removed. That would assist in fostering competition in the domestic market. This recommendation should be implemented only in the context of adopting the FSE approach for financial institutions (as discussed in Chapter 5) and not as an isolated amendment to Part IIIB.

10.38 It is noted, however, that the removal of the cap would result in additional administrative and compliance costs as foreign banks would need to substantiate the arm's length interest rate charged on the use of internal funds and the ATO would need to ensure adequate compliance has occurred. Those costs would be similar to those that must be met when associated entities are involved in the funding arrangement.

Recommendation 1

The Board recommends that:

- Subject to confirmation that the removal of the LIBOR cap would result in no material cost to tax revenue, the cap should be removed. That would assist in fostering competition in the domestic market. This recommendation should be implemented only in the context of adopting the FSE approach for financial institutions (as discussed in Chapter 5) and not as an isolated amendment to Part IIIB.

- It is noted, however, that the removal of the cap would result in additional administrative and compliance costs as foreign banks would need to substantiate the arm's length interest rate charged on the use of internal funds and the ATO would need to ensure adequate compliance has occurred. Those costs would be similar to those that must be met when associated entities are involved in the funding arrangement.

GLOSSARY

ABA	Australian Bankers Association
AFMA	Australian Financial Markets Association
AOA	Authorised OECD approach
ATO	Australian Taxation Office
Commissioner	Commissioner of Taxation
CUP	Comparable Uncontrolled Price
DTA	Double Tax Agreement
FSE	Functionally Separate Entity
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
KERT	Key Entrepreneurial Risk-Taking
LIBOR	London Interbank Offer Rate
OB activities	Offshore Banking activities
OBU	Offshore Banking Unit
OECD	Organisation for Economic Co-operation and Development
PEs	Permanent Establishments
RBA	Relevant Business Activity
SMEs	Small and Medium Enterprises
TOFA	Taxation of Financial Arrangements
TTI	The Tax Institute

APPENDIX A: SUMMARY OF OBSERVATIONS AND RECOMMENDATIONS

Observation 1

The Board notes that:

- PEs are significantly used in the financial sector, in part but not exclusively for regulatory reasons, but also by businesses in the non-financial sector.

- In considering the advantages and disadvantages of the adoption of the FSE approach, potential compliance costs for businesses in the non-financial sector, including those involved in the provision of services to the resources industries through the use of substantial equipment, need to be taken into account.

Observation 2

The Board notes that:

- The current Australian approach requires attribution to a PE of the actual income and expenditure/costs actually derived/incurred by the taxpayer in its transactions with third parties. The attribution under the RBA approach does not of itself exclude consideration of dealings between the PE and the rest of the enterprise of which the PE is a part and, indeed, should take account of such dealings. However, the FSE approach more explicitly and directly permits recognition of qualifying internal dealings as part of the attribution of profits to a PE.

- There is nothing in the FSE approach which would permit recognising qualifying internal dealings solely on the basis of accounting records or other documentation without substantiating the corresponding functional and factual analysis.

- The guidance contained in the OECD report on the attribution of profits to PEs may not prevent bifurcation or 'splitting' of 'risks' from single assets/contracts when they are substantiated by proper functional and factual analysis.

- Consideration should be given to asking the Commissioner of Taxation to provide guidance, under the current law, on whether and how internal derivatives, including those that are managed on a portfolio basis, may be sufficiently evidenced for recognition for tax purposes.

- If useful administrative guidance cannot be provided by the Commissioner under the terms of the current law, legislative changes should be considered to provide the required certainty.

Observation 3

The Board notes that:

- So far, only a limited number of countries have concluded treaties adopting the new Article 7 (and with it the full FSE approach).

- It is normal for model tax treaty innovations to take some time to be adopted in actual treaties.

- A decision for Australia to adopt the FSE approach should not be based on the extent of the current take-up of new Article 7 but rather on whether the FSE approach is a conceptually sound approach that would bring benefits to Australia.

- There is still very limited international experience from jurisdictions that have been administering the full FSE approach. At the same time, the experience from administration of the arm's length principle as applied to associated entities, which the FSE approach draws ideas from, may prove useful guidance when considering the administration of the FSE approach.

- There is limited specific OECD guidance on how the FSE approach applies in practice, which may contribute to an initial low take-up of the FSE approach as a new international standard. The lack of guidance may also result in complexities and uncertainties in its application to particular situations.

Observation 4

The Board notes that:

- Key advantages of adopting the FSE approach include:

  – Of particular relevance to banks, the FSE approach would more explicitly and directly recognise all internal derivatives that meet specified thresholds. In this regard, not taking account of internal derivatives as part of the attribution of profits to a PE has the potential to produce results that would not reflect the significant economic and commercial activities of a banking PE.

  – To the extent the common commercial practice is consistent with the requirements of the FSE approach, at least in terms of how banks manage risk, the FSE approach has the potential to not impose undue compliance costs on that sector (refer to discussion in Chapter 6).

  – To the extent that some of Australia's top two-way trading partners also adopt the use of the FSE approach in practice for the purposes of allocating profit to PEs, it would assist the goal of Australia being a financial centre as it would be consistent with that practice.

- The FSE approach more appropriately addresses the relative contribution of PEs where the enterprise makes an overall loss (as illustrated in Appendix C).

• Key disadvantages of adopting the FSE approach include:

- It could impose additional compliance costs and uncertainties for entities in the non-financial sector and for SMEs (refer to discussion in Chapter 6):

: These potential additional compliance costs and uncertainties are related to the need to substantiate qualifying internal dealings that are undertaken on an arm's length basis as opposed to only having to substantiate the allocation of actual external income and expenses to the PE.

- There is limited specific guidance in the OECD report on the attribution of profits to PEs on how to apply the FSE approach in practice. There is also very limited guidance on how a qualifying internal dealing could give rise to a foreign currency gain or loss that is relevant to the profit attributable to a PE. This lack of guidance may result in uncertainties in the application to particular situations.

• In addition, the tax revenue impact of adopting the FSE approach is not clear (see discussion in Chapter 6), for example as a consequence of:

- allowing a mark-up for services provided or received;

- allowing deductions for 'arm's length' royalties for use of a foreign entity's intellectual property;

- allocating economic ownership of assets as between a PE and other parts of the entity of which the PE is a part; and

- recognising internal interest charges for non-financial institutions.

• Particularly if the law is not amended to ensure symmetrical treatment of notional income and expense accounts for both the foreign PE and the Australian resident entity and also provision is not made for withholding tax on the relevant notional payments.

Observation 5

The Board notes that:

- An advantage of adopting the new Article 7 on a treaty by treaty basis is that it allows the Government to restrict the provisions of the full FSE approach to those jurisdictions that agree to apply those provisions on a reciprocal basis.
- A disadvantage of adopting the new Article 7 on a treaty by treaty basis is that it could take a considerable amount of time for treaties to be amended to incorporate the new Article 7, potentially resulting in a diversity of outcomes, including for non-treaty countries which would remain unaffected by FSE adoption in treaties only.
  - An option which would assist in restricting the diversity of outcomes would be to introduce amendments to the domestic law to reflect the more limited FSE approach (as per the 2008 OECD Commentary), which could be supplemented with bilateral negotiations with treaty partners.
- Adopting the FSE approach in full in domestic law would require consideration of the policy and law design in respect of a number of significant features of the FSE approach, including the treatment of royalties, rent and interest (for non-financial institutions), the treatment of capital (including whether to amend Australia's thin capitalisation rules) and the allocation of economic ownership of assets as between a PE and other parts of the entity of which the PE is a part.
- A more targeted option would be to adopt the FSE approach for financial institutions. This could be done through a modernisation of Part IIIB of the ITAA 1936, which would include its extension to Australian financial institutions and increasing the scope of the provision to cover financial arrangements as defined in Division 230 of the ITAA 1997. This targeted option would not impose the compliance requirements of the FSE on non-banks and SMEs.

Observation 6

The Board notes that:

- As a principle, it is preferable to have a consistent regime for the attribution of profits to PEs rather than sectoral regimes and for that regime to be consistent, to the extent possible, with that for dealings between associated entities.
- Any consideration of the adoption of the FSE approach through amendments to the tax law should include the potential impact on the diversity of industries and activities to which the PE attribution rules would apply, in particular those outside the banking sector (for example entities engaged in the provision of services to the resources industries through the use of substantial equipment and deemed PEs).

  - Any consideration of the FSE approach should include, as a key design feature, how it would be applied to entities outside the banking sector in order to minimise adverse compliance and administrative costs.

- Consideration should also be given to the potential impact on SMEs and the need for the development of simplified guidelines for the application of the FSE approach to SMEs, similar to what is currently done for SMEs in terms of the application of the arm's length principle.

  - This may involve, for example, the development of administrative guidelines that fit within a consistent legislative framework but cater for simpler or lower value dealings than commonly found in multinational banks.

- The principles to be applied in calculating the profit attributable to the Australian branch of a foreign financial institution should be the same as the principles to be applied in calculating the profit attributable to an overseas branch of an Australian financial institution (for the purposes of providing relief from any potential double taxation of income).

- Part IIIB should not be repealed unless there is certainty through appropriate guidance or legislation on the application of the tax law to Australian branches of a foreign bank and to overseas branches of an Australian bank.

Observation 7

The Board notes that the key effects of adopting the FSE approach would be:

- For Australian banks with foreign branches, to the extent they have adopted practices that are consistent with the requirements of the FSE approach; the FSE approach would provide more certainty, particularly with respect to their treatment of internal derivatives.

- For foreign banks with branches in Australia, the FSE approach would extend to arrangements not covered by Part IIIB, but if Part IIIB were repealed, the FSE would potentially create more complexity and compliance costs associated with the need to substantiate their qualifying internal dealings.

- For non-financial enterprises and SMEs, the FSE approach, as noted above, is likely to represent more complexity and higher compliance costs than the current rules, particularly due to the need to undertake functional and factual analysis and establish arm's length pricing on the provision of intra-entity services.

Observation 8

The Board notes the importance of:

- documentation relating to internal dealings, including derivatives, that is:
  - appropriate to the particular situation, enabling greater scrutiny than might otherwise be required for transactions between associated enterprises but generally not requiring such additional documentation that would impose costs and burdens disproportionate to the circumstances; and
  - consistent with and that supports the FSE's required functional and factual analysis.
- Functional and factual analysis that demonstrates the economic and commercial significance of the relevant dealing.

Observation 9

The Board notes that:

- A major issue for Australian banks is the uncertainty as to whether and, if so, how internal derivatives are to be taken into account in PE profit attribution. To the extent the Australian banks have adopted practices that are consistent with the requirements of the FSE approach; the FSE approach would enhance certainty for this group of taxpayers.
- To the extent that the requirements of the FSE approach are consistent with common commercial practice, the FSE approach would not impose undue compliance burdens.
- In other situations, however, the extra scrutiny required in respect of internal dealings as well as the application of the transfer pricing guidelines has the potential, without appropriate tailoring, to impose compliance burdens that are disproportionate to the circumstances. Concerns have been expressed in this regard on behalf of enterprises with short-term PEs and on behalf of small to medium sized taxpayers.
- The recognition of internal financial instruments in particular raises a number of complex issues, with attendant difficulties in, and costs of, administering the FSE approach. These difficulties could, however, be ameliorated by appropriate administrative safeguards relating to documentation of internal dealings and processes as well as the undertaking of appropriate functional and factual analysis.
- The tax recognition of internal dealings under the FSE approach is not without its difficulties in relation to determining the 'arm's length' reward for qualifying

internal dealings that meet the threshold requirements under functional and factual analysis. Administration of the FSE approach is unlikely to be straightforward, particularly in the context of very complex, high value and sophisticated cross border internal dealings. Should the FSE approach be implemented, fully or in part, robust administrative safeguards would be an important design feature.

Observation 10

The Board notes that:

- The FSE approach is conceptually apposite to the task of attributing profits to PEs that are separate and independent parts of an enterprise. In contrast with the RBA approach, the FSE approach works appropriately both when the enterprise makes an overall profit as well as when it makes an overall loss. The process by which the FSE attribution is done is simpler and more straightforward.

- The FSE approach conforms much better than the RBA approach to the way in which risk is allocated in a sophisticated banking setting. The traditional approach of allocating actual income and expenditure raises difficult questions when applied to complex portfolio management of risk.

Observation 11

The Board notes that:

- To the extent that adoption of the FSE approach would merely provide legislative support for current practices consistent with tax administration, it could be argued that there would be no impact on the tax revenue. However, it is very unlikely that such a conclusion could be arrived at without qualification.

- In general, the net tax revenue impact would depend on the effect of the FSE on the aggregate balance of functions, assets and risks in respect of dealings between non-resident entities and their Australian PEs. This would be affected by the extent of any amendment to the tax law to treat Australian head offices symmetrically to the treatment of the PEs and is also related to the potential imposition of withholding taxes on notional amounts.

  – A mark-up on services provided by non-resident entities to their Australian PEs would likely lead to a tax revenue negative outcome under the FSE approach.

  – A mark-up on services provided by resident entities to their offshore PEs would likely lead to a tax revenue positive outcome if the law ensured symmetrical treatment for both the PE and the Australian resident entity.

  - The ability of non-resident entities to deduct 'arm's length' royalties for use of their intellectual property in their Australian PE operations would likely lead to a tax revenue negative outcome under the FSE approach.
  - The ability to tax resident entities on 'arm's length' royalties for use of their intellectual property in their overseas PE operations would likely lead to a tax revenue positive outcome, if the law ensured symmetrical treatment for both the PE and the Australian resident entity.
  - The ability to impose withholding taxes on notional amounts would likely lead to a tax revenue positive outcome.

Observation 12

The Board notes that:

- Bringing the taxation of insurance enterprises under the general principles of the business profits article in Australia's tax treaties and adopting the FSE approach:
  - would assist in getting a more consistent application for insurance/reinsurance enterprises which operate in several jurisdictions and also in addressing the risk of potential double taxation, but
  - would have a potential unquantifiable cost to the tax revenue.
- It is the Board's view that, at this stage, the advantages of bringing the taxation of insurance enterprises under the general principles of the business profits article in Australia's tax treaties do not outweigh the potential risks to the tax revenue.

Observation 13

The Board notes that:

- If the FSE approach is adopted, further changes should be made to the law to ensure that for any amount that might be exempt from taxation in Australia resulting from notional expenses of a foreign PE, symmetrical tax treatment is given to those amounts as they affect the taxable income of the Australian resident entity. As noted in Chapter 6, this would contribute to a positive revenue outcome if the FSE approach were adopted.
- Consideration could also be given in this context to ensuring that the relief against double taxation in Australia resulting from notional income of a foreign PE only operates in respect of comparably taxed jurisdictions. This would assist not only in ensuring appropriate relief is provided from potential double taxation but also that there is not less than single taxation.

- Other amendments to Australian tax law following any adoption of the FSE approach, such as the imposition of withholding taxes on notional amounts, should only be implemented after due consideration is given to the effects on foreign investment in Australia.

Observation 14

The Board notes that:

- The FSE approach takes a more direct approach to dealing with the ways in which risk is allocated and managed within sophisticated multinational enterprises, such as banks, than more traditional approaches that start with the profits that the whole enterprise earns from the relevant business activity and imposes a limit on the profits that can be attributed to the relevant PE.

- The economic and financial environment in which multinational enterprises operate has been changing, and continues to change rapidly. This has implications for the design of any changes to implement the FSE approach; it would need to cater for ongoing change.

Recommendation 1

The Board recommends that:

- Subject to confirmation that the removal of the LIBOR cap would result in no material cost to tax revenue, the cap should be removed. That would assist in fostering competition in the domestic market. This recommendation should be adopted only in the context of adopting the FSE approach for financial institutions (as discussed in Chapter 5) and not as an isolated amendment to Part IIIB.

- It is noted, however, that the removal of the cap would result in additional administrative and compliance costs as foreign banks would need to substantiate the arm's length interest rate charged on the use of internal funds and the ATO would need to ensure adequate compliance has occurred. Those costs would be similar as those that must be met when associated entities are involved in the funding arrangement.

APPENDIX B: LIST OF PUBLIC SUBMISSIONS

Australian Bankers Association

Australian Financial Markets Association

Deloitte

Ernst & Young

Pitcher Partners

The Tax Institute

In addition, the Board received two confidential submissions

APPENDIX C: ILLUSTRATIVE EXAMPLES OF THE RELEVANT BUSINESS ACTIVITY APPROACH AND FUNCTIONALLY SEPARATE ENTITY APPROACH

1. The OECD's work on the attribution of profits to PEs highlights that there are two different approaches to the application of Article 7 of the Model Tax Convention on Income and Capital. There are referred to as the *relevant business activity* (RBA) approach and the *functionally separate entity* (FSE) approach, although both approaches can be applied in different ways by different countries.

2. Under the RBA approach, the 'profits of an enterprise' refer only to the profits of the business activity in which the PE has some participation. Article 7 is interpreted under this approach as imposing a limit on the profits that can be attributed to a PE, namely to the profits that the whole enterprise earns from the relevant business activity. In turn, the profits of the whole enterprise are those it earns from transactions with third parties and from associated entities (subject to the application of the transfer pricing rules to the latter).[16] However, a basic feature of Australian tax law is that (gross) income and expenses/costs must be attributed; 'net profit' is not directly attributed under the Australian approach (refer to paragraphs 3.5 to 3.11 of this report). As illustrated below, this form of the RBA approach (herein referred to as the 'current Australian approach') has implications, in the Australian context, for the comparison with the FSE approach.

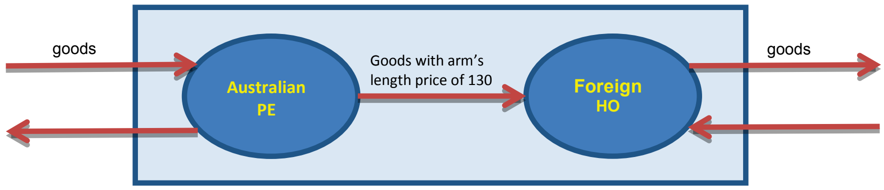
3. Under the FSE approach, the new Article 7 is interpreted as not limiting the profit attributed to the PE to that of the whole enterprise. In terms of the current Australian approach, this means that the new article 7 (if adopted) would not limit the profit attributed to the PE to the actual income and expenses of the whole enterprise.

4. The examples below seek to explain the two different approaches and illustrate where they may provide the same results and where they may provide different results. The examples are also used to comment on aspects of the two approaches. This is for the purpose of informing the Board's consideration of the advantages and disadvantages of the FSE approach and does not purport to be a view of how the current Australian tax law operates in a particular fact situation nor how the FSE approach, if it were adopted in Australia, would necessarily operate in that situation.

16 As noted in this report, the approach to the attribution of profits to PEs that is currently incorporated into Australia's tax treaties is the RBA approach.

Example 1

5. A foreign entity carries on processing through its Australian PE. The processing is of goods purchased from a third party for $100. The cost of processing is $10. In year 1, the PE transfers the goods it has processed to its foreign head office (HO). It is assumed that it is determined, under the functional and factual analysis, that the PE's operations are properly characterised as a sale of goods. The arm's length price for the goods is $130. HO sells the goods for $150 in year 2.[17]



6. The current Australian approach provides that because the enterprise has not sold the goods in year 1, there is no income from their sale to attribute to the PE in that year. This outcome is explained in TR 2001/11, which does at the same time provide for an administrative solution in respect of actual transfers of trading stock under certain conditions (refer to Example 2).

7. Under the FSE approach, the PE would be treated as having earned a hypothesised 'arm's length' profit of $20 (= $130 — ($100 + $10)) in year 1.

8. Accordingly, the FSE approach would result in the PE being subject to tax on $20 in an income year in which the foreign enterprise had earned no actual income that could be allocated. On the other hand, it could be said that measuring the PE's economic performance separately and independently of HO would lead to the conclusion that it has made a profit of $20 in year 1.

9. The FSE approach does not deal with the taxation of the foreign enterprise in its own country. An appropriate outcome, if it did, would be for the HO to be treated as having a profit of $20 (= $150 — $130) in year 2.[18]

Example 2

10. Assume that HO sells the goods in year 1 rather than year 2.

11. The enterprise makes a profit of $40 = ($150 — ($100 + $10)). The question is how that profit is to be allocated to the PE.

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17 The basic facts for Example 1 are drawn from TR 2001/11, paragraphs 5.11 to 5.16. However, the subsequent examples are not discussed in the Taxation Ruling.

18 Similarly, in the following examples an appropriate outcome for the HO would be an allocation arrived at by deducting the PE profit from the whole entity outcome.

12. TR 2001/11 provides an administrative solution in respect of actual transfers of trading stock to reflect 'arm's length' amounts recorded in the enterprise's accounts on a 'separate entity basis' if the accounts have been properly prepared and the attribution outcomes are the best estimate of PE profits that can be made in the circumstances: paragraph 5.16 of TR 2001/11.

13. On the assumption that the foreign entity incurred no other costs, the allocation under the RBA approach might be:

	Australian PE	Whole entity
Income	130	150
HO Costs		0
PE costs	(110)	(110)
Profit	20	40

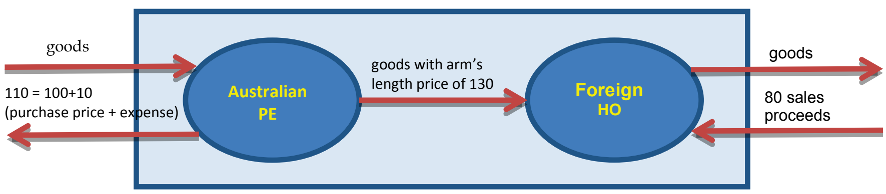
14. Under the FSE approach, the outcome would be:

	PE	Whole entity
Income		150
Internal dealing	130	0
PE costs	(110)	(110)
Profit	20	40

15. The outcome of attribution under both approaches in this example is the same. Both approaches start by considering what has happened under a functional and factual analysis. In the case of the FSE approach, there is a direct arm's length pricing of the internal dealing. It is important to note that to achieve the same outcome under the RBA requires that the allocation of the third party income and expense be done in a way that effectively has regard to the internal dealing at its arm's length amount; relative to the FSE approach, this could be seen as an indirect approach.

Example 3

16. Assume that the goods are sold by HO not for $150 but for $80. A functional and factual analysis reveals that the drop in sale price is not related to the operations of the PE.



17. In this case the foreign enterprise makes a loss of $30 (= $80 — ($100 + $10)).

18. Depending on the form of RBA approach adopted by a particular country, the outcome in this situation is that no profit is allocated to the PE. This is on the basis that there is no profit of the enterprise to allocate. Thus:

	Australian PE	Whole entity
Income	0	80
HO Costs		(100)
PE costs	(10)	(10)
Profit	(10)	(30)

19. The FSE approach would provide the following outcome:

	Australian PE	Whole entity
Income		80
Internal dealing	130	0
PE costs	(110)	(110)
Profit	20	(30)

20. While there is the same overall (enterprise) outcome, the two approaches in this case — where there is an overall loss — produced different outcomes.

21. However, this involved a form of the RBA approach under which profits are attributed to the PE. As noted in paragraph 2 above, the current Australian approach is that (gross) income and expenses/costs are attributed. Thus, while there is no (net) profit, there is income to be allocated. Essentially, there has been no change in the facts in example 2 in relation to the PE's activities. Under the current Australian approach (as set out in TR 2001/11), the allocation of income and expenses to the PE could produce the same net profit for the PE under either approach. Thus:

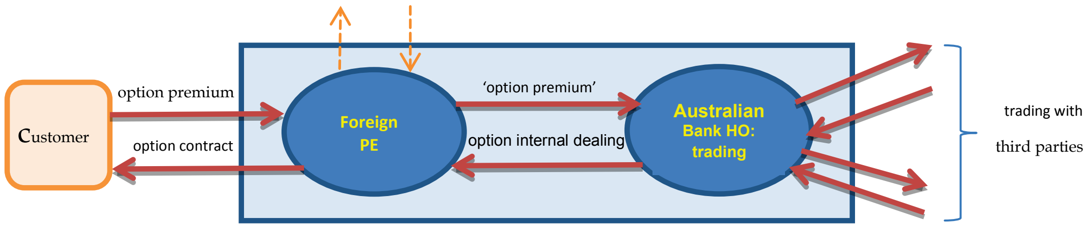
	Australian PE	Whole entity
Income	30	80
HO Costs		(100)
PE costs	(10)	(10)
Profit	20	(30)

22. This outcome could be achieved by allocation of the third party income in a way that effectively has regard to the internal dealing at its arm's length amount. A limitation on being able to do this is where the arm's length internal dealing price ($30 above) exceeds the third party income (for example, assume such income is, say, $25 instead of $150 or $80). This is unlikely to be a common situation, and in any event may often not be a practical limitation where arm's length aggregation of transactions outweighs such an effect.

23. It should also be noted that the scope of the RBA approach and the limitation of profit allocation under this approach (illustrated in example 2) depends on the scope of the relevant business activity.

24. Summarising examples 1 to 3, the FSE approach can produce quite different outcomes to the RBA approach for the different parts of the enterprise when the entity makes an overall loss. In practice, particularly in the context of the current Australian approach, this difference is likely to arise only in unusual situations although the process for achieving the same outcome as the FSE approach may be seen as requiring somewhat indirect solutions.

Example 4[19]



25. Banks operating on a multinational basis often deal in financial derivative instruments across jurisdictional borders. This may entail transfers of risk not only between associated entities but also between various parts of the one legal entity. This is one example of how and why this occurs.[20]

26. Assume that a customer in the country of the foreign PE wants to buy an option from the bank. The functions the PE can undertake and its position will influence what then happens. Assume that the PE does not wish to manage the risk of the position or is not in a position to manage the risk. The relevant risk will generally be market risk, but could be other types of risk such as credit risk depending on the circumstances. The PE may have the choice of transferring the risk to an unrelated third party or internally to the trading desk in the Australian bank HO, which may be in a better position to assume and manage the risk. In this situation, the PE could transfer the market risk to the HO by entering into an internal derivative transaction. In this case, this would be done by the foreign PE 'buying' an option from the Australian bank HO. The internal transaction, the option in this case, would be identical or very similar to the original transaction providing the foreign PE with a good offset of its risks. In practice, depending on the type of product, as there may be multiple risks in a single transaction, the foreign PE may choose to

19 The following examples assume that Part IIIB of the ITAA 1936 does not apply.
20 There are a variety of other ways in which a bank could organise itself to provide banking services to customers in different countries and deal with the risk that that involves.

retain some risk and transfer others to the Australian bank HO. It also may be that the individual risks are unbundled and transferred to different trading units within the one legal entity or even different legal entities within the group.

27. Banks that are market makers in derivatives typically seek to make a return either by locking in a spread or margin in their customer dealings, management of the hedge or by taking a speculative market position hoping that prices move favourably for the bank, or some combination of these actions.

28. The option premium that the customer is charged is typically calculated to cover the risks, capital and liquidity costs, trading costs, administrative and operating costs and the profit margin to the bank. Accordingly, in this example, that would include the PE's selling function and the risk management function carried out by the HO trading desk. The market risk management function can, in turn, be seen as a function of the cost of hedging or managing the market risk that is taken on by the bank.

29. In a competitive and liquid market and where the transaction is standard as well as having no special features which affect pricing decisions, the arm's length amount payable by the PE to the HO for managing the market risk — represented by the internal 'option premium' — should equate to what it would have had to pay on a wholesale basis to a third party bank for this function (a hypothetical transaction indicated by the orange dashed lines from the PE to outside the enterprise).

30. The bank's internal policies may, at the same time, be such that it would prefer that, where practicable, the PE deal with the HO rather than a third party so that the spread inherent in this internal 'option premium' stays within the bank. The cost of earning this spread may be minimal to the extent that the trading desk has a position that offsets the market risk that would otherwise be borne in writing the option.[21] In this situation, the trading desk may not need to enter into a specific offsetting option contract with a third party. In practice, specific aspects of the risk or the entire transaction may not need to be specifically hedged.

31. More generally, actions that the trading desk may seek to undertake as a consequence of taking on the market risk associated with the transfer of risk to it under the option internal dealing will depend on the resultant position for its trading book of financial instruments, and its trading or risk management strategy. Accordingly, it may:

    (i) enter into an offsetting option contract with a third party;

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21 The reduction of the cost of hedging in this situation may affect how the performance of the PE and the HO are measured by the bank.

(ii) bundle the exposure from the option internal dealing entered into with the foreign PE with other internal and external dealings and hedge all or some of the net amount with the market; or

(iii) not do anything further at that time (either because it has a matched book as a consequence of bringing the risk represented by the option internal dealing onto the book or because it seeks to take a position in the market).

32. How would the RBA approach allocate the option premium received from the customer between the PE and the HO? If the HO undertook the first action above, the exercise may be relatively straightforward in terms of the profit or loss calculation being based on actual income and expenditure (provided an objective and verifiable reference price for the transaction can be established). The second and third actions are likely to present difficult if not impossible exercises in tracing the customer option premium to third party transactions entered into or profits made or losses incurred by the HO. Development of any administrative guidance on this type of profit attribution (refer paragraph 3.28 of this report) would seem to need to take into account this difficulty.

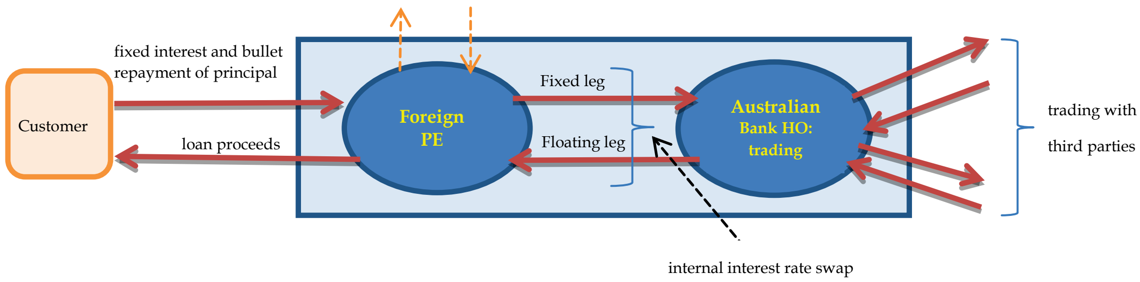
33. Say that the HO did not, as a direct consequence of the internal option dealing, enter into a third party transaction because it has a matched book as a consequence of bringing the risk represented by the dealing onto the book. The HO would nevertheless now have responsibility for managing the market risk in respect of the option and commercially should have capital to support the taking on of the risk. Depending on the changes in value of the actual option entered into by the bank, there may need to be a subsequent transfer of funds between the HO and the PE. Not taking the internal dealing into account in working out the tax consequences for the HO is likely to be distortionary because it would not reflect the commercial position of either the foreign PE or the HO. In effect, one of the components of the matched book would be missing from a tax perspective. Disregarding the internal dealing could give rise to considerable variability in taxable earnings from period to period even in a situation where, from the perspective of a matched book, the commercial earnings were relatively smooth. This should not, of itself, justify tax recognition of a particular dealing or lead to a conclusion that the FSE approach is the only approach that reflects commercial reality. Rather, this is to illustrate the implications of an approach that does not reflect such reality.

34. Under the FSE approach, the first question would be whether the option internal dealing is a qualifying internal dealing. If so, the transfer pricing guidelines would be applied to it in order to test whether it is priced according to arm’s length principles. Subject to these requirements and any other necessary and proper safeguards reflecting the circumstances of the transaction, the FSE approach would not need to differentiate between the different actions that the HO might take. It offers an alternative and, to some degree, a more straightforward process of analysis than the RBA approach in a complex portfolio management context.

35. The FSE approach would, however, not obviate potentially difficult transfer pricing issues. While these would exist in relation to derivatives transactions between associated enterprises (for some but not necessarily all transactions), there may be added complications. For example, the PE and the rest of the enterprise of which it is a part may or may not be subject to the same credit risk of other parts of the enterprise. Similarly, depending on various factors (for example specific entities used, credit enhancement structures, legal issues, governing documentation) where either the PE or the HO deals with an unrelated third party, the specific market price for comparable arm's length transactions may vary, sometimes significantly. Accordingly, an otherwise comparable derivatives price may have to be adjusted to obtain an arm's length price for the internal derivative dealing.

Example 5

36. In this example, the PE makes a fixed interest loan to a customer. The PE is exposed to rising interest rates and seeks to minimise this risk. It could enter into a third party interest rate swap (represented by the orange dotted lines) but, in accordance with the bank's policy and practice, instead deals with the HO, which is the central location within the bank for portfolio managing such risk, to hedge its risk. The PE does this by having an internal (interest rate) swap dealing with the HO such that it pays fixed and receives floating on a notional principal equal to the outstanding principal on the loan.



37. The PE in this situation is assumed to have a lending function which creates an exposure which, from its perspective, is hedged by entering into the internal (interest rate) swap. The HO, on the other hand, has a trading function in respect of the internal swap and would be expected to be compensated on that basis.

38. Suppose that the bank's policy and practice in respect of the PE was to hedge such risks, but that instead of HO being the sole location for hedging the interest rate risk, the PE has authority in appropriate circumstances to undertake hedging with third parties. Assume that it had in fact entered into a third party swap to hedge this particular loan. Sometime later the bank records an internal swap under which the HO receives fixed from the PE and pays it floating; HO also enters into an interest rate swap with a third party under which it pays fixed and receives

floating. Given that the risk was hedged before the PE enters into the internal swap and assuming that the PE does not have the function of managing risk of other parts of the bank, it may be asked what the internal swap represents and whether it should be recognised either under the RBA approach or the FSE approach. This illustrates that the documentation recording the internal derivative should not be determinative for tax purposes of risk allocation within an enterprise, and that a functional and factual analysis in terms of how risk is allocated within the particular entity is also very important for both approaches to PE attribution.

39. Further, documentation must be contemporaneous and not enable attribution of gains and losses to a particular location through actions that are, for example, effectively retrospective hedge designations. Otherwise, recognition of internal dealings could be used to distort profit allocation in a significant way.

Comments

40. These examples seek to illustrate that the FSE approach is conceptually apposite to the task of attributing profits to PEs that are separate and independent parts of an enterprise. The FSE approach works appropriately both when the enterprise makes an overall profit as well as when it makes an overall loss. In this situation, the RBA approach, particularly when it involves the attribution of (gross) income and costs/expenses (as in the current Australian approach) and depending on how the attribution is done, can generally but not always produce similar outcomes to the FSE approach. At the same time, the process by which the FSE attribution is done is more direct.

41. The FSE approach arguably conforms much better than the RBA approach to the way in which risk is allocated in a sophisticated banking setting. This is in the sense that the traditional approach of allocating actual income and expenditure can raise difficult questions of tracing when applied to complex portfolio management of risk, issues that the FSE approach does not need to address.

42. It may be thought that the recognition of notional transactions under the FSE approach introduces an element of artificiality into the income tax law, especially when juxtaposed with the consolidation tax rules which for income tax purposes disregard legal transactions entered into between members of a tax consolidated group. However, it can be argued that there is little or no dissonance between the two concepts when the role of each is considered.

43. The consolidation tax regime is designed to facilitate the taxing of wholly owned groups of companies that are, in substance, one economic unit as one economic unit.

44. Under international tax law, OECD member countries such as Australia are, in terms of the relations with other OECD member countries, allocated taxing rights according to a network of tax treaties. In the case of PEs, the situation is that a

single legal entity operates across jurisdictional boundaries requiring its profits and losses to be allocated to the relevant jurisdictions for income tax purposes. The way that the FSE approaches this, broadly speaking, is to respect the cross border dealing within the entity to the extent that it is between separate and independent parts of the enterprise, is properly and fully documented on a contemporaneous basis and is consistent with the analysis of the relevant functions, assets used and risks assumed. If so, the dealing is priced on an arm's length basis and used directly in attributing profits to the PE.

45. The separate and independent parts of the enterprise are similar in certain ways to separate economic entities. In this sense, both the FSE approach and consolidation seek to identify the commercial substance of the arrangements in question. This objective is strengthened under the FSE approach by the application of the arm's length principle embedded in the transfer pricing rules applied to the internal dealing.

46. This is not to say that the FSE approach is without its own practical difficulties. It centres on dealings that can have limited purpose outside tax. Administration of the FSE approach is unlikely to be straightforward. This will be particularly the case with non-standard transactions and complex and sophisticated high value cross border internal dealings. Implementation of the FSE approach would call for a premium on robust administrative safeguards including, for example, in relation to documentation (both legal and management policies).

47. The efficacy of the FSE approach, no less than that of the RBA approach, is reliant on the availability of objective and verifiable market prices, something which varies depending on industry and type of good (for example whether finished or intermediate, traded or non-traded, standard or bespoke).

48. Nor does the FSE approach obviate the need for a proper functional and factual analysis. This would be particularly important in a banking environment that is highly dynamic and involves very sophisticated dealings in risk as well as complex pricing arrangements.