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21 December 2012

The Manager
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The Treasury
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Email: transferpricing@treasury.gov.au

Dear Manager,

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

The Australian Bankers' Association (ABA) welcomes the opportunity to provide comments on the exposure draft (ED) and explanatory memorandum (EM) of the *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of transfer pricing rules*, issued by the Assistant Treasurer on 22 November 2012.

At the outset, we note that in light of the short consultation period, the ABA's comments are expressed at a high level. We believe that the changes proposed in the ED are fundamental to the Australian transfer pricing rules and deserve a fuller and more meaningful consultation with the taxpayer community.

ABA members welcome and support proposed amendments designed to update the transfer pricing rules contained in Australia's domestic law and align them with international transfer pricing standards set out by the Organisation for Economic Co-operation and Development (OECD). We also welcome the move to self-assessment, which is in line with other parts of corporate tax law and consistent with international practices.

We note, however, that these amendments should be done in a comprehensive manner and should provide a universal set of common, clear and consistent rules for separate legal entities and permanent establishments (PEs). Unfortunately, the ED and EM as currently drafted do not provide this clarity or consistency. The issue is of specific relevance to Australian banks, which use both legal entity and PE structures to invest offshore.

Our two key concerns are:

1. The proposed changes are seeking to selectively unpack and expand certain OECD concepts into domestic law which are (a) likely to allow divergence from OECD principles, with an unbalanced focus on profit methods and the unrestrained power to reconstruct transactions; and, (b) place a material additional compliance burden on Australian banks in relation to preparation of transfer pricing documentation; and

2. The inclusion of Subdivision 815-C in the Income Tax Assessment Act 1997 (ITAA 1997) before the conclusion of the Board of Taxation's review of the PE attribution rules. This legislation should be deferred until the Board's review is completed.

We have prepared our submission in the following sections:

- Executive summary
- Introduction of new laws relating to PEs before the conclusion of the Board of Taxation (BoT) review
- Scope of the proposed legislation: divergence from OECD Transfer Pricing Guidelines
- Onerous documentation requirements and access to reduced penalties
- Other observations

1. Executive Summary

The changes proposed are complex and require a much more thorough consideration. This is particularly the case for banks, which need to deal with the challenge of many differing rules for legal entities and PEs. The ABA submits that:

1. The introduction of subdivision 815-C of the proposed legislation should be deferred until such time as the BoT completes their review; and
2. Pending completion of the review, 815-C should be amended to specifically enable Australian Banks to adopt the Authorised OECD Approach[1] and recognise internal financial arrangements for PE profit attribution purposes. In addition, the reference to 22 July 2010 in 815-230(2) should be removed.

In the table below we summarise the key issues with the proposed legislation and our recommendations to Treasury.

No.	Issue	Recommendation
1.	Draft legislation for PE attribution before conclusion of the BoT review	• Defer introduction of 815-C until after the BoT review is complete. • Amend 815-C to specifically enable Australian Banks to adopt the Authorised OECD Approach.
2.	Diverge from OECD Guidelines contrary to policy intent	• Wording in proposed sections 815-130 and 815-230 "except where the contrary intention appears" should be deleted. • If not, then clarify that the rules will not go beyond OECD guidance in the EM and ED.
3.	Uneven focus on 'profit' outcomes vs transaction outcomes	• Amend ED and EM to reflect that traditional transactional methods are equally important, particularly for banks.
4.	Reconstruction	• Delete proposed sections 815-125(5) to (8) as they go far beyond OECD Guidelines and have the potential to be wrongly applied. • If not deleted make clear in the ED and the EM that the powers do not go beyond OECD Guidelines.
5.	Scope of documentation requirements	• Include in the ED and EM that a flexible 'risk based approach' to documentation should be followed, adhering to the "principles of prudent business management". • Clarify in the ED and EM that entity wide documentation is not necessary where transactional documentation adequately substantiates the arm's length position.

[1] That is, to adopt the OECD FSE approach as it applies for profit attribution purposes in the current version of the Model Tax Convention and Commentaries

No.	Issue	Recommendation
		• Clarify in the ED and EM that taxpayers can continue to rely on documentation prepared for an earlier year if there have been no material changes in the relevant income year. • Clarify in the ED and EM that taxpayers who currently have an Advance Pricing Arrangement (APA) are exempt from the need to prepare documentation in relation to dealings covered by the APA.
6.	Reasonably arguable position (RAP)	• Establishing a RAP should be linked to the reasonableness of the positions adopted by taxpayers not the preparation of documentation. • In the event that this stricter requirement is imposed on taxpayers, the ED or EM should clarify that it does not impinge on the Commissioner's power to remit penalties.
7.	Timing of documentation	• The ED and EM should remove the requirement that transfer pricing documentation needs to be prepared before filing the tax return. • Taxpayers should be allowed the flexibility of having the documentation ready in a reasonable timeframe when requested by the Australian Taxation Office (ATO).
8.	Time limit for amendments	• Should be restricted to 4 years at the maximum.
9.	Timing when new legislation would apply	• If enacted, legislation should have effect from the start of a taxpayer's next income year.

2. Introduction of new laws for the attribution of profits to PEs during the Board of Taxation Review

Delay any new legislation as it applies to PEs

The ABA did not expect to see Subdivision 815-C included in the ED dealing with PE profit attribution rules (PE attribution). We understood from the Consultation Paper (paragraph 59) issued by Treasury in November 2011 that decisions relating to the PE attribution rules would be treated as a separate policy question and not addressed in any rewrite of Australia's transfer pricing rules.

The introduction of new legislation in this area when the BoT is currently reviewing the PE attribution rules is very unhelpful and will add to the existing uncertainty in the way the current law applies to PEs. The ABA is very concerned that by attempting to introduce new legislation now, the urgency to modernise the PE attribution rules may be lost.

The ABA notes that the intention of the draft legislation is to repeal Division 13 of Part III of the Income Tax Assessment Act 1936 (Division 13 of ITAA 1936) containing the current PE attribution rules and replace it with Subdivision 815-C in the ITAA 1997. However, with the BoT's ongoing review of PE attribution rules due to be finalised in April 2013, and the likelihood that the Bill will not be passed by Parliament before then, we submit that the introduction of Subdivision 815-C is unnecessary at this stage and should be deferred until such time as a policy decision is made following the completion of the BoT's review. Meanwhile, the current PE attribution rules contained in the relevant sections of Division 13 of the ITAA 1936 should be retained.

Uncertainty created by new draft legislation

We understand from the EM that it is the intent of Treasury that Subdivision 815-C reflects the approach to the attribution of profits to PEs that is currently incorporated into Australia's tax treaties (the Relevant

Business Activity (RBA) approach). While the ABA accepts that this is likely the intent of the legislation, it is unclear whether the draft legislation meets that objective.

There is a risk that the new legislation may be interpreted in a way that is inconsistent or in conflict with the current approach to the attribution of profits to bank PEs. Such conflict could lead to increased confusion and uncertainty amongst the banks in what is already a highly uncertain and complex area of law.

Based on the wording of proposed section 815-201, which states that Subdivision 815-C "applies the internationally accepted arm's length principle in the context of PEs", and proposed section 815-205 which uses similar language to Article 7(2) of the OECD Model Tax Convention, it is unclear how this Subdivision should be interpreted. The internationally accepted approach to applying the arm's length principle in the context of PEs is the Authorised OECD Approach (AOA), being the Functionally Separate Entity (FSE) approach, which is at odds with the RBA approach underlying Australia's PE attribution rules. The ABA member banks unanimously support the adoption of the OECD approach for the recognition of internal loans and derivatives in determining the attribution of profits to PEs. This has been the long-standing view of the ABA, as communicated in our submission to Treasury dated 19 September 2012 in the context of Treasury's review of Australia's transfer pricing rules, and ongoing discussions with the ATO.

Further, although proposed section 815-225 clarifies that the "arm's length profits" for a PE are worked out by allocating actual income and expenditure of the entity between the PE and the entity, in defining "arm's length profits", there is some doubt over whether the new rules could apply to adjust the gearing of a bank that otherwise passes the safe harbour test in Division 820 of the ITAA 1997. In this regard, Subdivision 815-C should be amended to incorporate specific provisions confirming that proposed s815-225 will not override Division 820 as clarified in TR 2005/11.

In addition, with regard to Authorised Deposit-taking Institutions ADI's, TR 2005/11 provides for the recognition of 'internal loans' for the purposes of attributing actual income and expenses of a bank from 3rd party funding transactions as an acknowledgement that it is practically difficult and in some instances impossible to apply the current RBA approach to profit attribution. It is recommended that the principles outlined in TR 2005/11 with respect to the recognition of internal funding transactions be incorporated in Subdivision 815-C or at least clarified in the EM that these principles will be preserved.

Submission to the BoT

Our substantive submissions in relation to PE attribution issues are included in our response letter to the BoT dated 21 December 2012 in response to the Review of Tax Arrangements Applying to Permanent Establishments Discussion Paper October 2012. The ABA's submission to the Board of Taxation is attached to this letter.

3. Subdivision 815B: scope of the proposed legislation: divergence from OECD Transfer Pricing Guidelines

In principle, the ABA supports the adoption of OECD Guidelines in the proposed legislation as it applies to separate legal entities. The ABA does not, however, endorse the modification of these Guidelines through the incorporation of additional aspects into domestic legislation which attempt to broaden this scope. Such an approach is inconsistent with Government's policy objectives and has the potential to lead to increased compliance costs and the risk of double taxation.

This concern has arisen as the proposed sections 815-130 and 815-230 require the transfer pricing rules to be interpreted consistently with the OECD guidance "except where the contrary intention appears". With this exception, it remains unclear whether Australia is fully adopting OECD Guidelines or is leaving

the door open to modifications. The ABA is concerned that the proposed legislation is diverging from the OECD Guidelines by attempting to broaden the scope of the arm's length principle.

We understand that the policy intent is to align to OECD Guidelines and hence to be true to the intent, Treasury should remove this wording from the ED. If there are aspects which are not intended to align with OECD Guidelines, then this should be made clear in the ED and the EM.

In particular, the ABA is concerned about the practical risk of a 'profit' focus by the tax administration, the requirement to substitute the arm's length conditions for the actual conditions and the ability to reconstruct transactions in other than 'exceptional circumstances' which in the ABA's view goes beyond the intent of the OECD.

Focus on 'profit' outcomes

Australian banks typically deal with transfer pricing on a transactional basis using traditional transactional transfer pricing methods such as the Comparable Uncontrolled Price ('CUP') method. Profit methods may also be used but it is often not practicable nor reliable to apply an overall profit method to support the arm's length nature of many related party banking arrangements. The EM, at various instances refers to having regard to "totality of arrangements" between entities. We submit that concepts of entity wide assessment based on a totality of arrangements go much further than is required to implement the international standard on transfer pricing as espoused by the OECD.

The EM seems to suggest that it is the OECD Guidelines that allow for consideration of "totality of arrangements". It appears that the OECD references have been taken out of context[2] and are being wrongly used to support a modified arm's length principle that is focussed on a 'profit' outcome. These references in the EM to "totality' of arrangements" and an unbalanced focus on profit-based methods in the ED and EM could influence tax authorities to seek to assess transfer pricing benefits by comparing entity level profits. Given the diverse nature of banking operations, it would be practically difficult and require significant time and effort, resulting in material compliance costs to seek to identify an arm's length 'profit' outcome for the "totality of arrangements". This will clearly be at odds with how Australian banks manage their transfer pricing (in line with OECD Guidelines) by typically dealing with it on a separate transaction basis using transactional transfer pricing methods.

We recommend that the ED and the EM be amended to provide a more balanced view of transactional transfer pricing methods and explain how they can be the 'most appropriate' methods as per the OECD Guidelines, particularly for the banking industry.

Substituting arm's length conditions for actual conditions

Our understanding of the operation of the proposed rules is that it places an obligation on taxpayers to substitute the arm's length conditions for the actual conditions. We believe that this is quite onerous and will require banks to consider hypothetical arm's length conditions for a multitude of transactions which may or may not have an impact on pricing of the transaction.

Consider the case of an Australian bank that has multiple subsidiaries and PEs located in multiple offshore locations. Each of the locations operating outside of Australia undertakes a wide and diverse range of activities including funding, deposit-taking, lending, collateral management, assuming and managing market risks through derivative portfolios, mergers and acquisition advisory, etc. The interaction between the Australian head office and the offshore locations would differ from country to country and will also differ depending on the actual underlying line of business undertaken in each location. The offshore locations do not just deal with head office in a binary fashion; they will also have a

[2] In the OECD Guidelines, the reference to "totality of arrangements" is only in the context of reconstruction of transactions in exceptional circumstances

level of interaction amongst themselves, also depending on the nature of the lines of business undertaken in each individual territory.

In order to apply the ED to such an organisation that is multi-dimensional necessitates not only an assessment of the 'arm's length' conditions between head office and each country, but also the same assessment for each location amongst themselves. Banks currently analyse the individual transactions or portfolio of like transactions, and apply OECD Guidelines to establish that the transactions are arm's length. Requiring banks to look at the actual cross-border conditions operating between Australia and each of the offshore locations and to substitute them for the arm's length conditions is a step that is in addition to the work already done to establish that each individual transaction is arm's length. If this is the policy intent then it is an additional (and unnecessary) compliance burden which is not necessarily in line with the OECD Guidelines.

If this is not intended, we recommend that the ED should be amended to make it clear that it is only the 'economically relevant' conditions that need to be considered. In this connection, it would also be worthwhile clarifying that in performing a comparability analysis, the factors to be considered are only the ones that are 'economically relevant' to the particular transaction rather than all the factors. The substitution of arm's length conditions for actual conditions is concerning from the perspective of reconstruction of transactions, as discussed below.

Reconstruction

The ABA is concerned that taxpayers will be required under self assessment to reconstruct transactions subject to the relevant sections contained in Subdivision 815-B. This is a significant departure from the OECD Guidelines. The OECD Guidelines make it clear that tax administrations should only be permitted to disregard actual transactions in exceptional circumstances only[3] and does not place the onus to do so on the taxpayer.

In our view, proposed sections 815-125(5) to (8) go far beyond the OECD Guidelines. These sections provide a broad power for the ATO to disregard actual transactions and/or substitute other hypothetical transactions. The inappropriate use of these powers is very concerning for the ABA. Apart from the direct tax consequences of such an approach, reconstructing transactions creates uncertainty regarding the application of other parts of the domestic law, including flow on legal effects of the reconstructed transactions e.g. implications for debt/equity characterisation, withholding taxes, TOFA, etc.

We believe that having this additional power is not necessary. The existing OECD framework provides the Commissioner of Taxation (the Commissioner) with an alternative pricing basis in order to determine the arm's length price of the taxpayer's actual dealings. The Commissioner already has such reconstruction powers available to him under the general anti-avoidance provision (Part IVA) of the tax legislation.

We recommend that the ED should be amended to make it clear that taxpayers are only required to apply the transfer pricing provisions to the actual transactions entered into by them. There should be no requirement that taxpayers apply the tax rules to transactions that they have not entered into.

We also recommend that proposed sections 815-125(5) to (8) be deleted from the ED. In the event that these sections are not deleted, we submit that the ED and the EM should incorporate suitable language to bring the scope of these sections in line with OECD Guidelines regarding 'exceptional circumstances'.

Further, in the extreme/exceptional circumstances where it is considered necessary to reconstruct a transaction, we recommend that it should only be on determination by the Commissioner. It is not practical for banks to self assess the economic substance of all cross-border activities which are based

[3] OECD Guidelines, paragraphs 1.64-1.69

on legitimate business decisions and could involve significant and frequent movement of functions/people. This also highlights the importance why reconstruction powers need to be limited to exceptional circumstances only.

4. Onerous documentation requirements and access to reduced penalties

Scope of documentation

The ABA welcomes the approach of not having mandatory documentation requirements, however we note that preparation of documentation is necessary in order to substantiate RAP and access reduced penalties.

We appreciate the general requirement for taxpayers to prepare transfer pricing documentation to explain their transfer pricing arrangements to tax authorities. We believe this requirement should be balanced with the level of risk involved and the compliance burden on the taxpayer.

In the ABA's view, the annual requirement to prepare documentation in the form currently specified in Subdivision 815-D is onerous and does not provide this balance. In particular, the requirement to document "all actual conditions" and "all arm's length conditions" implies that all transactions may need to be documented regardless of materiality or potential risk which also implies that two sets of conditions and resultant tax outcomes need to be hypothesised. It will create an excessive compliance burden and result in significant additional costs for taxpayers. This is particularly the case for complex businesses like banks with multiple business units and inter-company transactions that may each need to be documented separately. The preparation of transfer pricing documentation at a transactional/policy level reflects the commercial context of banking operations.

We ask that Treasury clarify in the ED and EM that there is no requirement to prepare entity wide documentation when the transactional documentation adequately substantiates the arm's length position.

Rather than requiring all transactions and all conditions to be documented at the time of lodging a tax return, we would favour a more flexible 'risk based approach' to allow taxpayers to apply "principles of prudent business management" when determining the extent of documentation they may require to demonstrate compliance with the transfer pricing rules. This is supported by the OECD and also by the Commissioner in existing rulings regarding preparation of documentation (TR 98/11). This would ensure that the documentation takes into account the size and complexity of the transactions and the inherent transfer pricing risks associated with the transactions.

We also recommend that as in existing rulings, the proposed legislation allow for taxpayers to rely on documentation prepared for an earlier year if there have been no material changes in the relevant income year.

The ED and the EM should also clarify that taxpayers that currently have an APA are exempt from the need to prepare documentation in relation to dealings covered by the APA.

Reasonably arguable position

We believe that the link between documentation and having a reasonably arguable position (RAP) is an increased and more onerous requirement than the current rules. The current rules, both for transfer pricing and other tax matters, do not make documentation an absolute requirement for the purposes of establishing a RAP. The existence of a RAP solely depends on the reasonableness of the position adopted by the taxpayer which can be documented after the lodgement of the tax return. In the ABA's view, establishing a RAP should be linked to 'principles of prudent business management' when

determining the reasonableness of the positions adopted by taxpayers in complying with the proposed legislation.

Taxation Ruling 98/16 states in paragraph 30 that "in a practical sense, the test focuses on how well the processes and methodologies adopted by the taxpayer, and the outcomes achieved, reflect the arm's length principle". Further, the Miscellaneous Taxation Ruling 2008/2 that deals with shortfall penalties states in paragraph 52 that:

> *"the administrative penalty provisions do not require an entity to document their reasonably arguable position at the time that the statement is made. The Commissioner considers that, whilst the reasonably arguable position is determined at the time the statement is made, an entity has the opportunity to demonstrate their position when a shortfall amount in terms of subsection 284-80(1) is identified, which may be a number of years later."*

Banks generally have transfer pricing policies in place that require cross-border dealings to adhere to the arm's length principle. These are supported by processes embedded in the operations to ensure that policies are being applied. The application of the policies and procedures, together with documents such as inter-company agreements, invoices, etc provide the necessary comfort that the arm's length standard is applied to cross-border dealings. In the ABA's view, this should be sufficient for banks to obtain comfort and have a reasonable arguable position (which reduced penalties from 25% to 10%) by tax return lodgement date that no "transfer pricing benefit" has arisen under Divisions 815-B or 815-C.

The changes proposed in the legislation linking documentation to a RAP increases the existing threshold and are inconsistent with the policy objectives of the Government. The ABA submits that the existing rules regarding penalties are adequate and there is no need for a change which imposes stricter requirements.

We submit that this should be clarified in the ED and EM which could include deleting the relevant sections in the new law that seeks to increase the threshold.

However, in the event that this stricter requirement is imposed on taxpayers, the ED or EM should clarify that it does not impinge on the Commissioner's power to remit penalties.

Timing of documentation

In regards to timing, it is important to note that the preparation of transfer pricing documentation for banks is a complex, time consuming and costly exercise. The requirement to document "all actual conditions" and "all arm's length conditions" implies that all transactions may need to be documented regardless of materiality or potential risk by the lodgement of tax return. In the ABA's view, this requirement is excessive and will place an extraordinary burden on Australian banks to comply in the current form.

The preparation of transfer pricing documentation allows taxpayers to substantiate their position to the tax administration by documenting what the ATO currently refers to as the 'four-step' process. However, the documentation, in and of itself, does not alter the position that dealings of the taxpayer have adhered to the arm's length principle.

In the ABA's view, incorporating a deadline into the legislation to prepare transfer pricing documentation runs contrary to the move to self assessment. Taxpayers shouldn't be forced to complete 100% of their documentation every year by tax return lodgement dates as this will lead to significant burden at that time of the year when taxpayers are already dealing with compliance with a host of other requirements under the tax law.

Under the self assessment regime, taxpayers should be allowed to complete their transfer pricing documentation at an appropriate time which aligns with the needs of the business and time and costs

associated with preparing such documentation. It would be reasonable to require taxpayers to produce this documentation upon demand rather than expecting it to be prepared at the time of the tax return. A reasonable timeframe could be provided for taxpayers to respond to such requests.

Accordingly, we submit that no hard deadline should be incorporated in the legislation for taxpayers to prepare documentation. Rather taxpayers should be allowed the flexibility of having the documentation ready in a reasonable timeframe when requested by the ATO.

5. Other observations

Time limit for amendments

The ABA welcomes the introduction of a time limit for amending assessments. The EM does not provide any reasons why an eight year period for amendments is considered appropriate. The ABA believes that an eight year time limit is excessive. We believe that the time limit should be aligned with the general corporate tax amendment period of four years. We do not believe an eight year period is necessary to allow for Mutual Agreement Procedure (MAP) negotiations.

In this regard, we note that Australia's major trading partners that are OECD member countries generally apply a similar amendment of three to four years for transfer pricing matters. We have listed the countries in the order of their ranking in the global financial services centre index for[4] the banking industry which provides a good basis of benchmarking Australia against other countries in the context of Australia's stated policy intention of being a leading financial services centre.

OECD member country	Time limits for transfer pricing amendments	In top 10 global financial services centre for banking
United States	3 years	Yes
United Kingdom	4 years	Yes
Republic of Korea	5 years	Yes
Japan	6 years	Yes
Germany	4 years	Yes
Canada	6/7 years[5]	Yes
France	3 years	No
New Zealand	4 years	No

[4] The Global Financial Centres Index ranks the world's cities in accordance with their competitiveness as financial centres. The ranking takes into consideration both objective market indices and surveys undertaken by international financial services professionals. This index is then separated into sub-indices, one of which is the banking sector.

[5] 6 years for privately-owned Canadian companies; 7 years for publicly listed or foreign owned companies

Timing when legislation would apply

It is not clear from the ED or the EM as to when the proposed legislation is likely to start applying to taxpayers. We appreciate that the proposed legislation is subject to Parliamentary review, however, it would be beneficial for the taxpayer community to understand the effective date of operation as different taxpayers have different financial year ends.

The ABA recommends that the legislation should apply to individual taxpayers from the start of their first income year post passing of the legislation and this should be clarified in both the ED and the EM. To implement part way through an income year will add additional compliance burdens and administrative costs as many taxpayers review and prepare policy documents and transfer pricing documentation prior to the beginning of the year in which the pricing will apply. Any requirement to revisit the documentation requirements throughout the year as a result of the new law will require additional resources and potential cost for taxpayers.

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As outlined above, the ABA members welcome changes to the transfer pricing law for separate legal entities that brings it in line with international transfer pricing standards set out by the OECD. However, we are concerned that the legislation as currently drafted is going further than this international standard. It is also creating an additional documentation burden which will increase compliance and administrative costs without providing much needed certainty. The only avenue available to taxpayers to gain certainty regarding their transfer pricing arrangements is the ATO's APA program which itself is struggling to deliver outcomes within reasonable timeframes.

More importantly, for Australian banks, the introduction of Subdivision 815-C is unnecessary at this time and will significantly increase the level of uncertainty for taxpayers with branch operations in Australia and overseas adding complexity to what is already a highly uncertain and complex area of law. Any change in this area should wait until such time as a policy decision is made following the completion of the BoT's review.

As you would appreciate, the proposed changes have a far reaching impact on taxpayers, particularly to banks. These changes need to be carefully reviewed and deliberated before the legislation is implemented.

Yours sincerely,

Tony Burke

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Director, Industry Policy and Strategy

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21 December 2012

The Board of Taxation
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Dear Board of Taxation,

Review of tax arrangements applying to permanent establishments

The Australian Bankers' Association (ABA) welcomes the opportunity to provide a submission to the Board of Taxation (BoT) in response to the Review of Tax Arrangements Applying to Permanent Establishments Discussion Paper of October 2012 (BoT paper).

ABA member banks unanimously support the adoption of the Authorised OECD approach (AOA) for the attribution of profits to permanent establishments (PEs). The OECD approach is wholly in line with established industry practice, as communicated in our meeting with the BoT on 29 August 2012 and our submission dated 19 September 2012. The ABA has also made a public submission to Treasury on these issues, in the context of Treasury's review of Australia's transfer pricing rules (2 December 2011).

Important trading partners in the financial services community have largely been adopting this approach either in law or in practice for some time. After more than ten years of work and consultation, the OECD issued its report on this matter in 2008, finalising it in 2010. Australia was a major contributor to the OECD's thinking on this subject through representation on the OECD's working group and appeared to be an advocate for its application. It is unfortunate that Australia's position on this issue is still being debated, especially in the context of recent legislation aimed at modernising Australia's transfer pricing rules, aligning subsidiaries with OECD best practice, but not PEs.

Adoption of the AOA will align Australia with international best practice and remove the uncertainty arising from the current rules. The ABA believes the AOA is a more robust model for correctly attributing profits to PEs than Australia's current rules, which have not been updated to reflect the way in which banking operations have developed. This is because the AOA explicitly recognises and prices inter-branch dealings in a way which is consistent with the long-standing commercial operations and accounting practices of Australian banks. Adoption of the AOA will provide Australian banks with a legislative basis to support the long-standing practice of recognition of specific inter-branch dealings for the purposes of correctly attributing profits to bank PEs.

Failure to adopt the AOA is at odds with the Government's stated ambition of developing Australia as a financial services centre. Australia's global ranking as a financial services centre has fallen from 7th to 15th in the past five years[1]. Taxation has been identified as an important factor for competitiveness, with

[1] The Global Financial Services Centres Index, September 2012 (http://www.longfinance.net/Publications/GFCI%2012.pdf).

perceived fairness the main concern. Consistency and stability in tax and regulation is required in order to promote Australia as a financial services centre, and aligning the PE attribution rules with the AOA is an important step in that direction.

This issue has been on the agenda for a considerable amount of time and we have been unable to agree on an appropriate and practical approach to interpretation with the Australian Taxation Office (ATO). The ABA submits that the incorporation of the AOA into legislation is the right approach to achieve certainty in this area.

As noted above, the ABA has already had extensive consultations with the BoT and has previously made detailed submissions which, amongst other things, detail how inter-branch derivatives operate. Therefore, it is not the intention of this submission to respond to each question raised in the BoT paper. Rather, the ABA's comments are expressed at a high level and focus on the key reasons for legislative change to implement the AOA for allocating profits to PEs of Australian banks.

We have prepared our submission in the following sections:

- Importance of Australia adopting the AOA and the recognition of internal dealings for PE profit attribution purposes
- International take-up of the AOA among OECD countries and Australia's Asian trading partners
- Impact of adopting the AOA on domestic taxation revenues, and compliance and administration costs
- Implication of implementing the AOA on a treaty by treaty basis or incorporation into Australia's domestic law
- Impact on Australia's attractiveness as a leading financial services centre
- Other considerations

1. Importance of Australia adopting the OECD approach and the recognition of internal dealings for PE profit attribution purposes

Current Australian PE rules

To date, the only practical guidance issued by the ATO on PE attribution issues are Taxation Ruling TR 2001/11[2] and TR 2005/11[3]. TR 2001/11 indicated that the ATO intended to issue a separate ruling dealing with PE attribution issues that are of special importance to, or are particular to, multinational banks, but to date this has been limited to issues related to inter-branch funds transfers in TR2005/11.[4] We understand that TR 2005/11 was never intended to apply solely as an administrative concession for loans. The purposes and immediate focus of this ruling was to preserve the principles in the former Interest Paid Adjustment (IPA) agreement and to respond to the introduction of specific UK branch capital rules for foreign banks by some of Australia's major trading partners (including the United Kingdom), with the assumption that other transactions would be adequately addressed at a later stage once the OECD work in this area was further advanced.

TR2005/11 effectively adopts the AOA in practice through providing for the recognition of 'internal loans' for the purposes of attributing actual income and expenses of a bank from 3rd party funding transactions as an acknowledgement that it is practically difficult and in some instances impossible to apply the current approach to profit attribution. Similar compliance challenges arise in relation to other key inter-branch dealings such as derivative transactions. These are almost always managed on a portfolio basis, and hence it is not practicable to determine which specific transactions have given rise to the risk and

[2] Income tax: international transfer pricing – operation of Australia's permanent establishment attribution rules
[3] Income tax: branch funding for multinational banks

therefore identify actual third party income and expenses, which is required in applying the current Relevant Business Activity (RBA) approach. In the absence of any legislative rules or specific ATO guidance on the PE attribution issues relating to such inter-branch dealings, and in light of the principles set out in TR 2005/11, banks have been principally applying the AOA and guidance as an appropriate market driven mechanism for allocating profit in accordance with the business profits articles. The ATO has been aware of this.

In addition, some banks have obtained Advance Pricing Arrangements (APAs) from the ATO which accept that the functionally separate entity approach can be appropriately applied to cross-border dealings that occur within the global derivative trading platform.

With respect to foreign bank branches, the operation of Part IIIB of the Income Assessment Act 1936 (ITAA 1936) effectively allows an Australian branch of a foreign bank to be treated as a separate legal entity and not a PE, accordingly, certain notional derivative transactions between the branch and Head Office reflected in the accounting records of the branch are recognised as if they were between separate legal entities. The legislative intent was to recognise the difficulties in attributing profit (allocating income and expense) to different parts of the same legal enterprise.

It seems that in response to ABA requests dating back a number of years for clarity on the treatment of inter-branch dealings (in the context of the application of the Taxation of Financial Arrangement (TOFA) rules to inter-branch derivatives), the ATO provided a discussion paper on 6 July 2011 contending that the "separate entity approach" does not extend to internally recorded 'derivatives' because they do not necessarily reflect real hedging expenses incurred by the bank in hedging contracts with 3rd parties.

The ATO position was not expected by ABA members. Not only was it provided on an issue which was not in the scope of the TOFA discussions that had been held between the ABA, Treasury and the ATO over many years prior to the introduction of the TOFA regime, but also it was in direct contrast to what was understood to be a consensus position that had previously been subject to numerous reviews, without challenge by the ATO, through various compliance activities involving industry members over the years.

The fact that the industry practice should suddenly be called into question by the ATO has given rise to considerable uncertainty about how Australia's PE attribution rules should be applied to modern banking organisations. This is an unworkable situation for Australian banks.

Compounding this issue is the recent release of draft legislation aimed at modernising Australia's transfer pricing rules, which in its current form, codifies the current Australian PE attribution rules, based on the RBA approach, which requires actual income and expenses to be allocated between a bank and its PE. The introduction of draft legislation on this issue when the BoT review is ongoing is of significant concern to ABA members (see Subdivision 815-C of the Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of Transfer Pricing Rules). ABA members believe that legislating Subdivision 815-C prior to the outcome of the BoT review could lead to a loss of momentum in pursuing reform of this important issue.

As noted in our submission to Treasury on the draft legislation, the introduction of new Subdivision 815-C is unnecessary at this stage and will significantly increase the level of uncertainty for taxpayers with branch operations in Australia and overseas, adding complexity to what is already a highly uncertain and complex area of law. The ABA believes that any change in this area should wait until such time as a policy decision is made following the completion of the Board of Taxation's review. A copy of the ABA's submission to Treasury is attached.

OECD approach for recognition of internal dealings and profit attribution

The AOA is consistent with the best current international thinking and practice on the application of the arm's length principle in a PE context, particularly as it relates to banking and global trading. The application of the Australian Relevant Business Activity (RBA) approach, as now advocated by the ATO, is inconsistent with this approach. The AOA does not require institutions to trace back to the source of actual income and expenses of the entity in order to attribute arm's lengths profits. It also permits the recognition of internal dealings such as derivatives as a way of attributing profits, provided they are priced at arm's length.

The objective of the AOA is to apply to dealings within a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. Like the Australian guidance, the OECD acknowledges 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. However, importantly, the OECD states that:

> *"internal dealings should have the same effect on the attribution of profits between the PE and other parts of the enterprise as would be the case for a comparable provision of services or goods...between independent enterprises."*[5]

With respect to internal derivative dealings, there are various sound commercial reasons that such dealings arise, including efficiency and centralisation of risk management in a hub location. This helps banks to manage a number of risks, including but not limited to interest rate, currency and credit risk. Internal derivative dealings reflect where risk is managed by the appropriate specialist dealers within banks and their recognition provides a reliable basis to ensure there is an arm's length allocation of profits between the head office and PE. 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. The AOA more appropriately reflects the commercial operations, accounting records and systems and processes for deal capture of Australian banks, which typically do not differentiate between foreign branches and subsidiaries for the majority of cross-border related party transactions.

It has been a long accepted practice that the starting point in any attribution exercise is the financial statements of the PE determined by the ordinary processes of good business accountancy which generally provide a fair reflection of the economic functions performed and the assets utilised by the PE. Consequently, recognising such arrangements as per the accounts for tax purposes is in alignment with the approach prescribed by OECD guidance and results in arm's length profit attribution.

Capital attribution issues

We note that the issue of capital attribution has also been raised by the BoT discussion paper. This is a complex and unsettled area. As acknowledged by the OECD, the debt-equity characterisation and thin capitalisation rules as well as the capital allocation approaches, vary from country to country. 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

[5] OECD 2010 Report on the Attribution of Profits to Permanent Establishments, 22 July 2010, para 173.

interest that is deductible for tax purposes. We also note that this approach is consistent with the taxation of subsidiaries that are subject to domestic thin capitalisation rules while applying OECD guidance with respect to related party transactions. Any change to the existing thin capitalisation rules in Australia, as they might be applied to either PEs or subsidiaries should be the subject of much wider consultation and would require new draft legislation.

Consistency for subsidiaries and PEs

If Australia's PE attribution rules are not aligned with the AOA, Australian banks will be faced with the prospect of applying the international consensus approach to associated enterprises, but a non- OECD compliant approach to PE activities.

The ABA's view, was, and remains, that the arm's length principle and AOA should be consistently applied in Australia's transfer pricing rules to both separate legal enterprises and PEs. If the AOA is not adopted, this would produce a potential disparity in transfer pricing outcomes between taxpayers operating through subsidiaries and PEs, which is out of step with the OECD consensus view.

Recognition of notional internal dealings for other purposes of Australian 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 (e.g. TOFA). It should not be recognised for other corporate and indirect tax purposes of the law (e.g. interest withholding tax). This treatment is consistent with the current guidance in TR 2005/11 which recognises that for 'internal loans', the internal charge should not be treated as an interest payment subject to withholding tax for purposes of Division 11 of the ITAA 1936.

This is also consistent with the guidance in Taxation Ruling 2006/9[6] which addresses interest withholding tax in the context of attributing interest between an Australian bank's Australian business and the business of its overseas PE, where the bank has obtained the relevant funds through the PE.

We also note 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 interest withholding tax on similar dealings, for example Singapore and Hong Kong[7].

2. International take-up of the AOA among OECD countries and Australia's Asian trading partners

We would like to provide some observations on comments contained in the BoT Paper which states that "The authorised AOA has had an uneven take-up internationally so far" and that "A number of OECD countries (including New Zealand) have entered reservations to the change [in the new Article 7] 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."

The vast majority of OECD member countries do in fact support Article 7(2) of the Model OECD Convention, which endorses the AOA either in law or practice. This includes Australia's major trading partners in financial services such as the United Kingdom, the United States, Hong Kong and Singapore as well as all EU member countries. Japan is also considering adopting the AOA.

As noted in the ABA's submission to the BoT dated 19 September 2012, a review of the Observations and Reservations that have been lodged with respect of Article 7(2) of the 2010 OECD Model

[6] Income tax: interest withholding tax – cross-border inter-branch funds transfers within resident authorised deposit-taking institutions

[7] In addition, Canada, Japan, Hong Kong, Singapore, South Korea, and the UK do not charge withholding tax on internal funding transactions between a local tax resident and offshore branch.

Convention indicates that the countries that have expressed reservations regarding Article 7(2) are New Zealand, Chile, Greece, Mexico and Turkey. Portugal has expressed a reservation, but merely to allow for an amendment to the domestic legislation to accord with the amendments to the Article. Of the 5 OECD member countries which have expressed reservations, only New Zealand has particular relevance to Australian banks in terms of PE operations.

New Zealand is a major trading partner for Australia, with Australian banks often operating through subsidiary structures in New Zealand or undertaking funding transactions with New Zealand branches which are afforded the AOA under Australian tax rulings. As such, we do not anticipate significant issues between Australian and New Zealand operations if Australia adopts the AOA and New Zealand continues to reserve its current position.

Even among non-OECD members, the majority of Australia's top two-way trading partners support the use of the AOA in practice for purposes of allocating profit to PEs.

The table below shows Australia's top 10 two-way trading partners and whether in practice they accept the AOA in the determination of profits attributable to branch operations and/or accept the new Article 7 and Commentary in applying attribution principles under local tax law.

Australia's top 10 two-way trading partners 2011*					
	OECD Member	**Top 10 Global Financial Centre****	**Accept new Article 7 in domestic tax law**	**Accept AOA in practice *****	**Comments**
1. China	✓		✓	✓	• Observer status with the OECD and generally respects and follows OECD Guidelines. • Banking PEs are generally taxed on their actual profits based on audited financial statements`
2. Japan	✓	✓			• The Japanese Ministry of Finance, is considering introducing the "force of attribution" concept and the AOA into its domestic tax law for the attribution of profits to PEs. • The target date for change is not confirmed, but may be part of the 2014 Tax Reform.
3. United States	✓	✓		✓	• Treaty by treaty basis domestic attribution rules also in place. There are a number of treaties which contain the revised Article 7.
4. Republic of Korea	✓	✓		✓	• Korean tax authorities generally respect internal transactions in determining profit attributable to branch operations. • Discussions to amend Korean tax law to clarify adoption of Article 7 concepts.

5. Singapore		✓	✓	✓	• Technical income sourcing rules should be curtailed under treaty provisions of the DTA.
6. United Kingdom	✓	✓	✓	✓	
7. New Zealand	✓				• Explicit reservation made to the revised Article 7 (2010).
8. India					• In its capacity as an observer nation, Indian Revenue has expressed disagreement with OECD principle of recognising internal dealings between the head office and its PE on an arm's length basis.
9. Thailand				Partial	• Although the Thai tax law does not accept the OECD business profits and guidance, Thai tax authority tends to follow the OECD guidance, except for some certain expenses which are required to be charged at cost.
10. Malaysia			N/A subsidiaries only	N/A subsidiaries only	• Generally tax authorities adopt the arm's length principle and authorise the use of TP methodologies endorsed by OECD Guidelines.
11. Hong Kong		✓		Partial	• This is a developing area of the law. Hong Kong revenue is not bound by OECD principles but in practice will draw reference to the OECD attribution principles.

*Source: Australian Department of Foreign Affairs and Trade – Trade at a glance 2012:http://www.dfat.gov.au/publications/trade-at-a-glance-2012.html

** Source: The Global Financial Centres Index 12, September 2012: http://www.longfinance.net/Publications/GFCI%2012.pdf

***Generally accepts principles as guidance in practice. May be some specific cases where approach differs.

Many Australian banks have branch operations in these countries and therefore for Australia to retain the current RBA approach for profit attribution when major trading locations accept the AOA can have significant implications for Australian banks, which is discussed further in the sections below.

The broad support for the AOA among OECD members and Australia's trading partners demonstrates that the AOA represents the most appropriate methodology for attributing profits to PEs based on international consensus. The fact there is a limited number of dissenting member countries who do not support the principle should not in itself prevent Australia from adopting the AOA, so that its profit attribution rules are in line with general international consensus.

In this context, it is also worthwhile noting that Australia has not recorded any reservation to the new Article 7 (including the related Commentary). This indicates that not only did Australia support the AOA

but also suggests that Australian representatives were expecting that domestic rules would be changed to align to the OECD guidance. Furthermore, Australian representatives at the OECD were at the forefront of developing the current AOA, so the international business community will quite understandably expect Australia to adopt the approach approved by the OECD.

3. Impact of adopting the AOA on domestic taxation revenues, and compliance and administration costs

The BoT has invited comments on the potential impact on domestic taxation revenues, and compliance and administration costs of adopting the AOA. The ABA understands that the Government is concerned that a change could lead to substantial leakage of revenue.

In the ABA's view, the adoption of the AOA should be a principle-based decision driven by the need to bring Australia's rules into step with international consensus. Any assessment based on revenue impact would not be equitable and would be prejudicial to taxpayers, particularly Australian banks. In any case, as argued by the ABA in previous submissions, while the impact will differ for individual banks, reflecting the different foreign branch networks and cross-border transaction flows of each bank, ABA members are not aware of any potential significant revenue impact for Australian banks in aligning the domestic PE rules with the AOA. This is because most banks are already applying the AOA for allocating profit in relation to inter-branch funding and derivative transactions, as noted above. In fact, we note that in the case of Australian-headquartered banks providing outbound services to their foreign branches, adoption of the AOA 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.

At a time when most of the OECD member countries and also Australia's trading partners are moving to adopt the AOA, continuing with the current RBA approach carries the risk of significant double taxation (or less than single taxation). As a result of double taxation, there is increased potential for disputes with Australia's treaty partners, which drains taxpayer and ATO resources. Where such disputes take place, it is highly likely that many of Australia's treaty partners would insist on the adoption of the AOA under a mutual agreement procedure.

Besides the potential double taxation, 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, in light of the volume and speed of transactions, systems for deal capture and accounting and the fact that risks are largely managed on a portfolio basis. Taxpayers would face increased compliance costs in maintaining separate accounts for tax and accounting purposes, as well as reconciling the differing approaches in cases where a multinational operates in both Australia and in a country which adopts the AOA.

A move to adopt the AOA to attributing profit to PEs is not expected to have a material adverse revenue impact, however it would provide greater certainty for taxpayers.

4. Implication of implementing the AOA on a treaty by treaty basis or incorporation into Australia's domestic law

The ABA supports the incorporation of the AOA into Australia's domestic law as opposed to a treaty by treaty approach. In this regard we refer to the approach adopted in the UK whereby the OECD rules (including the AOA on attribution of profits to PEs) have been incorporated into the tax code. We also note that this is consistent with the approach taken in the draft legislation aimed at modernising Australia's transfer pricing laws.

An approach that involves 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 of the DTA 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.

5. Impact on Australia's attractiveness as a leading financial services centre

As acknowledged in the BoT paper, and for reasons set out by the ABA in previous submissions, multinationals in the banking sector tend to operate through branch structures, and this sector is possibly the most impacted by the PE attribution rules.

The banking sector is a significant part of the Australian economy and a large contributor to corporate tax revenues annually. In the ABA's view, the Australian Government has the opportunity to align Australia's PE attribution rules with the AOA in order to bring certainty in the taxation of inter-branch dealings.

We note that an important consideration in deciding whether to amend Australia's PE attribution rules is that they should not inhibit Australia's attractiveness as an investment destination. The ABA contends that the uncertainty and divergence from international tax standards impacts the confidence of multinationals to invest and conduct business in Australia.

While the ABA recognises that embracing the AOA in itself isn't sufficient to respond to increasing international tax competition, reducing the tax uncertainty through embracing the AOA would almost certainly remove a perceived barrier to competition.

6. Other considerations

While the ABA members submit that the AOA should be incorporated into Australia's domestic law, we also recognise that participants in other industries may not be affected in the same way.

In this regard, 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 should 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.

We thank you for your consideration of this important matter. We would be pleased to discuss the comments in our submission with you further.

Yours sincerely,

Tony Burke