AFMA

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The Manager
International Tax Integrity Unit
The Treasury
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Email: transferpricing@treasury.gov.au

Dear Sir/Madam

Exposure Draft – Stage 1 Transfer Pricing Reforms

The Australian Financial Markets Association (AFMA) represents the interests of over 130 participants in Australia's wholesale banking and financial markets. Our members include domestic and foreign banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. We think it is important that companies with international operations pay their fair share of tax on the profits they make in Australia. In this context, we appreciate the opportunity to comment on the Exposure Draft (ED) legislation to implement stage 1 of the transfer pricing reforms.

The policy context for the proposed law change extends well beyond the short and long term tax revenue objectives. In particular, these measures will form an important part of the regulatory fabric that governs the international capital flows that support Australia's productivity and economic development, as well as our engagement with the Asian Century.

Transfer pricing rules should be certain, transparent and strike a balance in protecting Australian tax revenue and facilitating international business. Key summary points in our submission are:

- The ED legislation should apply only a prospective basis;
- Permanent establishments of both domestic and foreign owned banks should be taxed on a functionally separate entity basis;
- The ED legislation should specifically recognise Part IIIB of the Income Tax Assessment Act 1936 as a code for taxing foreign bank branches and update Part IIIB to cover all intra-bank financial arrangements;
- The ED legislation should promote greater tax certainty by minimising the risk that the arm's length internal transactions of a branch or subsidiary business may be re-characterised for tax purposes.

1. The Economic Context for the Transfer Pricing Reform

Australia typically runs a significant current account balance of payments deficit of about 3% of GDP, so our ongoing economic development depends in part on capital account investment from overseas. Moreover, because our economy has a strong focus on international commerce, both inward and outward capital flows contribute significantly to our economic development. For instance, the total inward stock of direct investment in Australia was $494 billion in 2010, while direct investment from Australia to other countries was $377 billion.[1]

New opportunities will continue to present for Australia as balance of global economic activity and power continue to shift over time. At present, there is particular focus on high Asian growth that, amongst other things, is producing large middle classes and an associated increase in demand for services. For example, the Prime Minister has cited the potential for Australia to benefit from Asia's economic development through financial services exports.[2] More generally, the Asian Century provides significant growth opportunities to Australian businesses across a range of sectors, including commodities and services.

It is important that Australia makes the right policy choices to foster economic development, promote competition in banking and respond to the challenge of lifting our productivity. Evidently, the tax transfer pricing rules will apply to a substantial volume of economic business conducted in Australia and by Australian companies overseas. The design and execution of tax policy in this area is a highly relevant consideration in this context. A well-founded set of transfer pricing rules will support Australia's international trade and investment, whereas an incomplete or poorly constructed set of rules could harm our economy.

2. Retrospective Application of the Amendments

Australian companies seeking to build international businesses must accept and manage significant commercial and operational risks. Businesses with international branch and subsidiary operations must also manage regulatory risk, which must be minimised if we are to foster their growth. In particular, certainty in the tax system is important to taxpayers who have to make decisions on a daily basis about the structure, organisation and management of their business affairs, including financing and investment decisions. A well-structured tax system that provides certainty and fair outcomes to business contributes to our international competitiveness.

In this context, AFMA is concerned that the ED provisions go beyond providing a mere clarification of the transfer pricing rules and are in effect a retrospective change to the law that will apply as far back as 2004. There appears to be a consistent and strong view amongst the business community and tax advisers that the proposed change is not in

[1] See ABS, Cat. No. 53520, reported in Business Council of Australia, Assessing Australia's Trade and Investment with Asia.

[2] 'Building a new Australian economy together", Australia-Israel Chamber of Commerce lunch, 1 February 2012.

the nature of a clarification but rather would amount to a retrospective change to the law.[3] Apart from potentially imposing uncertainty and significant administrative costs on taxpayers to re-assess positions, this would create the potential for double taxation.

Taxpayers need to be able to rely on the tax law as it is written and to have confidence in the fair and effective administration of the tax system. These are features of a mature governance system within an economy and they are highly relevant to the good international competitiveness of Australia as a place to invest in and to conduct business, as outlined above. For these reasons, we would argue that the ED legislation should be changed to operate prospectively.

The current debate about the retrospective application of the proposed amendments to the law highlights the obligation on governments and the tax authorities to be clear and transparent about the full intended application of the law at the time that it is enacted.

3. Foreign Bank Branches (permanent establishments) in Australia

There are currently 48 foreign owned banks in Australia, of which 39 are branches and 9 are subsidiaries. The Banking Act requires that a foreign bank's retail banking business must be conducted in a locally incorporated subsidiary. The preference for branch operations to conduct wholesale banking reflects a steady trend away from bank and non-bank financial institution subsidiaries since the foreign bank branch regime was introduced in 1993, which has occurred for commercial and regulatory reasons. The global financial crisis (GFC) has adversely affected the business of foreign bank branches in Australia, but while their market share (in terms of banks' Australian assets) has reduced by over 40%, they remain a vital source of competition in the wholesale banking market.

Part IIIB of the Income Tax Assessment Act 1936 applies separate entity treatment to foreign bank branches (and to branches of foreign financial entities) in Australia for key intra-entity transactions. This is the strongest feature of Part IIIB for foreign banks and tax administrators, as it provides tax certainty for funding and certain other intra-bank transactions and the application of arm's length rates to those transactions.

AFMA's members are concerned about the risk that the ED legislation could be applied in a way that would in effect set aside or undermine the operation of Part IIIB by ATO seeking to instead rely on the transfer pricing provisions of a tax treaty, where one exists. There are no policy grounds to leave open the risk that a retrograde step of this nature might be taken. To the contrary, the evidence is that the separate entity provisions in Part IIIB have operated in the way intended by Parliament and the ED legislation would only serve to increase tax uncertainty for foreign bank branches.

Division 815 may adjust taxable income, decrease taxable loss or adjust capital gains but this adjustment is not based on a transactions approach (ie not referable to any specific transaction) and, hence, is not contemplated in Part IIIB. Therefore, it is unclear how

[3] For example, see the Tax Institute's submission to the Treasury consultation paper "Income Tax: Cross Border Profit Allocation – Review of Transfer Pricing Rules", November 2011.

retrospective application to 2004 can be applied to bank branches taxed under Part IIIB (ie did not elect to be taxed under the treaty). Moreover, foreign jurisdictions have relied on Part IIIB, so uncertainty would arise about the availability of foreign tax credits consequent to a retrospective Division 815 adjustment.

It is vital that the role of Part IIIB as the primary taxation code for foreign bank branches is left undisturbed by the proposed legislation. We recommend that in order to close off the risk of a different outcome, the ED legislation should be amended to include an explicit carve-out for entities that are taxed under Part IIIB. This would preserve the policy principles that applied when foreign banks opened, or transferred their business to, a permanent establishment and confirm the assurance given to them that this would apply to them on an ongoing basis. This would involve no cost and no risk to tax revenue but it would maintain the certainty and efficiency of the tax system for foreign bank branches, which is especially important at a time when their businesses are under significant pressure in adjusting to the post-GFC environment.

In addition, further reform is required to provide a comprehensive set of tax rules that will support the integrity of the Australian tax system as it applies to foreign bank branches, while providing the level of certainty necessary to promote an even greater contribution for foreign bank branches to competition in banking and to the Australian economy more generally. In particular, the ED legislation should be amended to:

i. Modernise Part IIIB by updating it to cover <u>all</u> intra-entity financial arrangements (as defined in Division 230) and not just those currently specified in Part IIIB. Technical deficiencies in the scope of Part IIIB have emerged since it was enacted in 1993; largely due to the development of the banking and financial markets since then (eg carbon derivatives did not exist in 1993).

ii. Clarify the law to confirm that the capital allocation requirement for a foreign bank permanent establishment is determined under the thin capitalisation provisions in Division 820. This approach would confirm the position set out in TD 2002/28 in relation to Division 16F, which was the precursor to the current thin capitalisation rules and was considered to provide a code for dealing with debt/equity funding from third parties.[4] This would also be consistent with the understanding we were given during the consultation discussions in the development of the thin capitalisation legislation. Alternatively, the capital allocation requirements could apply on similar terms to Part IIIB (ie the taxpayer may elect to be taxed under the treaty if it gives them a better outcome).

This approach would provide significant benefits for both taxpayers and the ATO by streamlining the law, improving its efficiency from an administrative perspective and removing legal uncertainty. This would also enhance the competitiveness of Australia as

[4] TD 2002/28, paragraph 7, states in respect of third party funding "To the extent that Division 16F applies to such funding, it limits Australia's DTA taxing rights in respect of thin capitalisation.

an international business location, which is important given the significant leakage of financial business activities offshore.[5]

There would be no cost to tax revenue to adopting this approach; for example, we understand that foreign bank branches that elect out of Part IIIB continue to apply the same transfer pricing policies. Moreover, banking and financial transactions generally present less challenging transfer pricing challenges for tax administrators because of the high (and increasing) level of price transparency in financial markets, the high frequency and relative standardisation of financial transactions and the commoditisation of risks.

Hence, AFMA recommends that the approach presented above should be implemented by an amendment to the ED legislation.

4. Foreign Permanent Establishments of Australian Banks

Proposed Division 815 applies to dealings between an Australian entity and its foreign associated entities and to an Australian permanent establishment of a foreign entity. It does not address the situation or needs of the overseas permanent establishments of Australian-owned banks.

AFMA supports the prospective alignment of Australia's transfer pricing rules for Australian banks with outbound investments with international practice, as outlined in the OECD 2010 Guidelines. We believe that permanent establishments of both foreign banks with branch operations in Australia and of domestic banks that have offshore branch operations should be taxed on a separate entity basis. This approach is consistent with the principles of tax neutrality and it would be in line with the OECD approach to permanent establishment taxation, which best reflects international practice. We are not aware of any revenue cost to adopting this approach.

A broader application of the separate entity approach to permanent establishments of both inbound and outbound financial institutions would promote tax efficiency, support tax revenue, reduce tax risk and compliance costs and enhance Australia's global competitiveness. Therefore, we recommend that this approach be adopted in the law and the administration of our tax system.

This approach would be consistent with the Review of Business Taxation (1999) recommendation that the separate entity treatment of permanent establishments should be introduced on a progressive basis.[6]

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[5] The 2011 *AFMA Operations Survey* Report presents a declining trend in the percentage of traditional back office functions conducted in Australia. Back office functions are being taken or directed away from Australia, offshoring of IT is common practice, operations staff numbers have declined by 22% since 2008 and the cost of operations and tax rates are important factors in offshoring for many firms.

[6] Recommendation 22.11 - General treatment of branches - *Progressive introduction of separate entity treatment*

That the law be rewritten over time to permit, in appropriate circumstances, separate entity treatment of dealings between a branch and other parts of the entity, starting with the supply or acquisition of trading stock.

5. Promoting Greater Business Certainty under the ED Legislation

As we understand it, the ED legislation would give the Tax Commissioner a significantly greater capacity to set aside transactions of a subsidiary or branch that satisfy the arm's length criterion under a comparable uncontrolled price analysis and to re-characterise transactions in way that ATO believes reflects its profit expectations for an entity. In general, we think the latter approach should only be adopted in practice when there is a lack of reliable comparable transactional data but there is nothing explicit in the ED legislation or the Explanatory Memorandum to promote this particular outcome. The OECD transfer pricing guidelines allow a reconstruction in exceptional circumstances only. On the evidence of the SNF case, ATO may seek to apply this approach in a wider range of scenarios. There should be legislative boundaries around such extensive powers before they are given to the administrator.

There are significant practical issues to be managed in applying the law in this area. For example, the financial services industry is constantly changing and business restructures are common; particularly post the GFC. The tax consolidation regime adds to this complexity, with sometimes disparate businesses being brought together under one entity, leading to less clarity around the post-tax result for particular business lines. In addition some businesses within banks are viewed as complementary and integral to a full-service product suite, even if one particular arm of the business is not consistently profitable. Hence, it is sometimes difficult to determine a standardised profit level that can be applied in simple form to a particular industry participant.

Against this backdrop, great care needs to be given in the application of the law to properly account for the specific nature of a particular business and the commercial factors explain its relative profitability. The starting point for a transfer pricing analysis should always be the actual transactions undertaken by a taxpayer including related party transactions and if those transactions can be shown to be at arm's length based on comparable data then the law should not give the ATO power to nevertheless adjust the taxpayer's overall profit by comparison to its competitors.

6. Other Issues

Treasury may wish to give further thought to how the proposed rules will work in practice and whether they may give rise to unintended outcomes, which could ultimately require further changes to the legislation. For example, unintended outcomes may arise from the potential for transactions conducted on commercial terms to be reconstructed for tax purposes in certain circumstances. Treasury should also be comfortable that the inbound focus of the ED legislation cannot be successfully challenged under the anti-discrimination article of the relevant treaty.

The proposed approach will mean that entities from treaty countries are disadvantaged as ATO may assess them under either Division 13 or under the tax treaty, depending on which ATO believes will give a better outcome for tax revenue.

7. Concluding Comments

Thank you for the opportunity to comment on the ED legislation. If it would be helpful, we would be happy to discuss the matters raised in this submission with you at your convenience.

Yours sincerely

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