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The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

17 December 2012

Dear Ms Chaplain

**Re: Review of tax arrangements applying to permanent establishments**

Deloitte welcomes the opportunity to submit comments to the Board of Taxation for purposes of the review and in response to the Discussion Paper of October 2012. Our comments below address specific issues and questions raised in that document, and are made under the various headings in that Discussion Paper.

**Deloitte's View**

Deloitte has a unique perspective in relation to this issue. Whilst at the Australian Taxation Office (ATO), David Grecian and Marc Simpson spent many years representing Australia's view at OECD level in relation to the issues of application of the arm's length principle to the attribution of profits to permanent establishment. David chaired Working Party 6 at OECD level for much of the period where many of the issues canvassed in the Board of Taxation paper were discussed. Marc was Vice-Chair of the same committee, and while at the ATO was lead author of TR 2001/11 and TR 2005/11 – key ATO rulings providing interpretation of the application of the arm's length principle for branches under Division 13 and Article 7.

In our view, the Board of Taxation should provide a strong recommendation that Australia adopt the new Article 7 and legislate it domestically into the new s815-C of ITAA 1997.

The key reasons for this are:

- Australia has already incorporated through s815-A the "limited AOA", and the key differences between the limited AOA and the AOA (functional separate entity approach) relates to the recognition of internal royalties, internal interest for non-financial institutions and recognition of mark-ups for 'routine' services.

- Apart from that, we do not believe that there are significant differences in practice between the outcomes under the AOA and under the single entity approach as historically adopted by Australia

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- For the financial services sector, there is little to no difference between the limited and full AOA, as the limited AOA recognises the concept of economic ownership of financial assets, and internal dealings such as interest and risk transfers for the purposes of attributing profit according to the arm's length principle having regard to economic substance. One of the most fundamental changes brought about by the 2008 Commentary is that it is no longer appropriate to treat (banking) PEs as mere service providers, with all of the risk, and therefore equity capital, residing in head office.

- As such, of itself, we consider there to be no quantifiable revenue impact of moving to the AOA under the new Article 7

- The adoption of the new Article 7, of itself, is limited to the attribution of profits to permanent establishments and recognises 'transactions' for the purposes of attributing profit based on functional activity and economic substance. Under the new Article 7, such internal dealings are not in themselves recognised as legal transactions for any purpose including for other treaty articles.

- The adoption of the new Article 7 is key to resolving the potential for double taxation in a branch context including a number of remaining inconsistencies in the old Article 7 and its 2008 OECD Commentary

- For MNCs straddling many borders, including Australian-owned MNCs, the OECD work is the only internationally recognised and harmonious guidance on these matters. It is vital to have a common set of rules to allow businesses to run efficiently, promote investment into Australia and reduce the risk of double taxation.

- We are of the view that Australia's thin capitalisation rules should remain unchanged, and the approach set out in TR2007/10 and s815-A in relation to the interaction between the thin capitalisation rules and transfer pricing rules provides sufficient clarity if there are differences between the arm's length amount of capital under Article 7 and Australia's thin capitalisation requirements

- For insurance, the proper application of the principles set out in the AOA should lead to an appropriate arm's length allocation of profits to PEs involved in the operation of an Australian insurance business. We consider it timely that discussions occur on whether it continues to make sense to maintain Division 15 of the Income Tax Assessment Act 1936.

- Given the difficulties (recognised in the Johnson Report) with the Libor cap in Part IIIB in relation to inbound bank branches, in our view, the arm's length principle (in conjunction with the thin capitalisation provisions) provides a better framework to determine deductible debt in Australia

In this submission we provide the context of the OECD work and explain why Deloitte supports the adoption of the new Article 7.

## Chapter 4 – The Authorised OECD Approach ("AOA")

At the time of the adoption of the AOA by the Committee on Fiscal Affairs in June 2006, only New Zealand (at the time a Vice –Chair of the Committee) and one other East European country expressed disagreement with the "economic substance" approach in the AOA. While agreeing the Committee had asked for the 1995 Transfer Pricing Guidelines approach to be adopted for Article 7 (the mandate of WP 6) the countries' main objection was the overturning of the traditional OECD single entity approach, as they saw it.

A particular issue for most countries was the economic approach to the ownership of intellectual property within the single entity which contradicted the historical position of the OECD of not sanctioning the payments of royalties by a PE to another part of the same legal entity. However, most countries could see that the concept of economic ownership of financial assets was essential to the proper arm's length reward to the banking/global trading PE and that it would be internally inconsistent to apply a different principle for the ownership of IP. The economic ownership approach is also employed for tangible assets, albeit citing 'use' as the most relevant economic indicator.

The essential problem concerning royalties and to a lesser extent services was the historical approach of the OECD which was designed primarily to appease non-members and was seen as not creating a wedge with the UN on these issues.

However, the most significant issue at the June 2006 Committee meeting was the vexed question of symmetry, which largely remains unresolved in the 2008 Commentary but which is solved by the 2010 Commentary as applying to the new Article 7.

Essentially, the new Article 7 is required to resolve the potential for double taxation. The potential for double tax arises for two main reasons. The first is the AOA approach to the attribution of capital. It was not possible to agree on only one attribution method because the UK insisted on the "thin capitalisation method" in situations where the Basel approach was not possible (e.g. technically bankrupt banks with insufficient capital as in certain German Lander banks and certain Japanese banks at the time). Thus two arm's length approaches to attributing capital are sanctioned but many countries reject the "thin cap" approach and do not accept they are legally obliged to provide double tax relief when the method is used by the host country.

The second reason for the potential for double tax lies in the application of the arm's length principle itself, which is obviously open to various judgements and approaches. The existing Article 7 has no equivalent to Article 9(2) and thus many countries, at least at an official legal position, do not accept an obligation to provide symmetry and necessarily accept the host country position. Importantly, the new Article 7 resolves any potential for double taxation.

## Chapter 5 – Adopting the Authorised OECD Approach in Australia

### Q. 5.1 Issues/Questions

***What are the implications for the domestic tax law and for tax treaty policy of Australia adopting the authorised OECD approach (AOA)?***

In our view, the implications for the domestic tax law and for tax treaty policy of Australia adopting the full AOA are relatively limited.

As discussed below, this is because there are not substantial differences between the full AOA and the approach under current Australian tax law in accordance with Subdivision 815-A *Income Tax Assessment*

*Act 1997*, Taxation Rulings TR 2001/11 and TR 2005/11, and the 2008 Update to the Commentary on Article 7 of the OECD Model Tax Convention (the "limited AOA").

As a result of the enactment of Subdivision 815-A ITAA 1997, much of the AOA has already been incorporated into Australian tax law, at least for Australian PEs in treaty cases.

In summary, our understanding of how Subdivision 815-A affects the attribution of profits to PEs under Australian tax law is as follows:

- 815-A is a power to adjust PE profit attribution for income years commencing after 1 July 2004
- 815-A is an adjustment power separate from ss.136AE(4)-(6) of Div.13 *ITAA 1936* and the Business Profits Article ("Article 7") of an applicable treaty
- 815-A only applies to treaty cases, i.e. where Article 7 of a treaty applies
- 815-A explicitly only applies to Australian PEs; offshore PEs of Australian residents are unaffected
- 815-A requires that both it and the applicable Article 7 be interpreted consistently with the OECD Model Tax Convention, but only to the extent that it is relevant
- The OECD MTC includes the Commentary to Article 7 of the Convention
- 815-A provides that, for income years prior to 2012-13, the OECD MTC that is relevant is that last published before the start of the relevant income year.
- For income years commencing after July 2010, the Commentary to Article 7 OECD MTC included a new Article 7 and Commentary for that new Article. This Commentary fully incorporated the 2010 OECD *Report on Attribution of Profits to PEs*, which stated the authorised OECD approach (AOA). The full AOA is a functionally separate entity approach. As Australia has not yet negotiated any treaty that includes the new Article 7, the full AOA is only relevant to interpreting 815-A, and only for years post 2010.
- For income years commencing after July 2008, the Commentary to Article 7 OECD MTC partially incorporated the AOA (to the extent that it did not conflict with the pre-2008 Commentary). Australia has accepted the 2008 Commentary to Article 7 OECD MTC without observation.
- The 2010 Commentary preserves the 2008 Commentary for the old Article 7. All of Australia's current treaties include the old Article 7. Therefore, under 815-A the partial AOA is relevant to interpreting 815-A for income years post July 2008 and pre July 2010 and to interpreting the applicable old Article 7 for all income years post July 2008.
- The ATO interprets ss.136AE(4)-(6) of Div.13 ITAA 1936 and old Article 7 as requiring a single entity approach (see TR 2001/11 and TR 2005/11). It considers this consistent with the pre-2008 Commentary to Article 7 OECD MTC. On this basis, TR 2001/11 and TR 2005/11 are relevant to how the ATO would apply 815-A for all income years from 1 July 2004.
- Subsection 4(2) *International Tax Agreements Act 1953* prevents treaty override, so that it prevents 815-A being applied to tax more profit than would be allowed under Article 7. Therefore, the full AOA could not be applied under 815-A so as to subject more profit to tax than would be permitted by the partial AOA under the applicable old Article 7.

The partial AOA, as implemented through the 2008 update to the Commentary on Article 7 of the OECD MTC, incorporates all but a few aspects of the full AOA that are considered in conflict with the pre-2008 Commentary, i.e., internal royalties, mark-ups on some service charges, and internal interest for non-financial institutions. In other words, in all respects other than these, Subdivision 815-A incorporates the AOA into Australian law in applying and interpreting both that provision and the Business Profits articles of Australia's tax treaties. Prior to, and without the enactment of Subdivision 815-A, the 2008 changes to the Commentary on Article 7 of the OECD MTC of themselves incorporated this partial AOA into Australian law in applying and interpreting the Business Profits articles of Australia's tax treaties. On this basis, we consider that the implications for the domestic tax law and for tax treaty policy of Australia adopting the full AOA are limited. However, as noted in comments in Chapter 4 above, the new Article 7 and Commentary are important from the perspective of relieving double tax and removing otiose paragraphs from the article

Quite apart from the effects of enacting Subdivision 815-A, in our view there are generally not material differences in practice between the outcomes under the AOA and under the single entity approach as historically adopted by Australia. In this regard, we make the following points:

- The practical application of both the AOA and the single entity approach, as per TR 2001/11, most commonly involves the same two-step process: a functional analysis, under which functions, assets and risks of the entity in respect of the business conducted though its PE are attributed to the PE, so as to economically characterise the PE and its internal dealings with other parts of the entity; and a comparability analysis, under which those dealings are priced at arm's length by analogy to separate entity transactions.
- 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 AOA's functionally separate entity approach only recognises a PE's internal dealings for purposes of attributing profit to the PE under Article 7 OECD MTC; the internal dealings are not in themselves recognised as legal transactions for any purpose including for other treaty articles.
- 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. Essentially, the two approaches give the same outcome except in situations, which are limited in practice, where the entity does not derive sufficient actual profit from the business to give the PE an arm's length return for its functions, assets and risks. This would never be the case, for example, for a large bank or insurance company.
- 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 reqhbhuire the tracing of internal dealings and charges to the entity's third party transactions and actual amounts of its income and expense. TR 2001/11 recognises this for internal trading stock transfers of PEs, and TR 2005/11 does so for internal interest dealings of PEs of financial institutions. In these situations, the recognition and arm's length pricing of a PE's internal dealings is, of itself, taken to achieve an appropriate attribution of the entity's income and expense to its PE. In these situations, the attribution outcomes of applying the AOA and the single entity approach are the same.
- At the time they were written, TR 2001/11 and TR 2005/11 were explicitly informed by the development of the OECD position on the attribution of profits to PEs, of which Australia was a major architect.

***Should the AOA be adopted on a treaty by treaty basis or as part of Australia's domestic law?***

In our view the AOA should be adopted as part of Australia's domestic law, through a revision of the current (draft) s815-C.

***Should there be special rules in Australia for capital allocation to branch operations if Australia adopts the AOA?***

We do not consider there to be any need to change the existing Division 820 thin capitalisation rules in relation to capital attribution to branches if Australia adopts the full AOA.

***What would be the impact on current tax practices of adopting the AOA?***

As discussed above, we consider 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.

**Q. 5.2 Issues/Questions**

Australia was a lead architect of the OECD work on attribution of profits to PEs. In the context of Australia directly legislating the OECD Guidelines on Transfer Pricing into its domestic legislation (as has occurred for s815-A, and likely to occur for s815-B and s815-C), rejection of the new Article 7 and associated Commentary would likely have significant ramifications for Australia's reputation as an investment destination, particularly in the financial services sector.

**Chapter 6 – Adopting the AOA – specific kinds of operations**

**Q. 6.1 Issues/Questions**

From a regulatory perspective, branches of financial institutions such as banks and insurance companies are increasingly treated as if they were separate legal entities. For example, under the Insurance Act 1973 and prudential standards authorised therein, foreign general insurers (i.e. Australian branch operations of foreign companies licenced to conduct insurance business) are obliged to meet minimum capital requirements based on the assets and liabilities of the Australian branch. In a banking context, a recent example is the proposed requirement to report liquidity coverage and net stable funding ratios will be applied on the basis of domestic (i.e. Australian) books only for Australian branches of foreign Authorised Deposit-Taking Institutions (ADIs), based on a November 2012 Discussion Paper released by the Australian Prudential Regulatory Authority (APRA).

The principles of the AOA, and specifically the full adoption of the "functionally separate enterprise" approach in relation to branches, is closer to the regulatory environment in which branches operate and ensures that the tax analysis is not divorced from the reality of the operational and commercial circumstances faced by financial institutions.

Further, the heightened prudential requirements and regulatory scrutiny on the branches of financial institutions provide a safeguard for the principle included in the OECD Commentary to the Model Tax Convention since 1977 that trading accounts of branches can be relied upon as a starting point in ascertaining the profits attributable to the branch

**6.2 Issues/Questions**

***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 AOA***

As previously discussed, the general position of the 2008 Commentary on Article 7 OECD MTC and the ATO's domestic position are the same. The functional analysis, including assets used and risks assumed, is the official approach to the attribution of profits. In banking, the fungible pool of funds approach is adopted and internal loans and arm's length interest charges are acceptable. In banking, the determination of the risk bearing part of the entity is vital to determine the funding of the PE. The AOA as it relates to the funding of banking PEs was adopted in total in the 2008 Commentary.

The AOA deals at length with the determination of the economic owner of financial assets and the original risk bearer and subsequent transfer of risk. The importance of this aspect of the AOA on the attribution of profits to banking PEs cannot be overstated, as prior to the 2008 Commentary the OECD was effectively silent on the issue of funding PEs and the need for capital.

One of the most fundamental changes brought about by the 2008 Commentary is that it is no longer appropriate to treat (banking) PEs as mere service providers, with all of the risk, and therefore equity capital, residing in head office. Under the 2008 Commentary, the financial assets and the initial and subsequent risk bearing will be attributed according to the functional analysis. For purposes of attributing financial assets, the key entrepreneurial risk taking function determines the initial attribution. Risk may subsequently be transferred by way of derivatives. As long as the internal dealings reflect the arm's length principle, they are accepted for purposes of attributing the arm's length profit to the PE for purposes of Article 7. As previously discussed, the ATO rulings mimic the OECD in this approach.

In July 2011, the ATO published a paper entitled *"Profit allocation to permanent establishments of banks"*, in which it essentially took the position that internal derivatives could not be recognised for purposes of allocating a bank's profits to its PE. In doing so, it relied on the single entity approach to argue that internal derivatives do not necessarily reflect actual expenses of the bank in hedging transactions with third parties. In our view, the ATO paper fundamentally misunderstands the arm's length approach under the AOA and under Australia's current law. The legal reality of an entity not being able to transact with itself is trite and goes nowhere when applying the arm's length principle to determine the source country taxing rights on the profits of a PE. Nothing in the ATO rulings, properly understood, supports the reasoning in the paper. Both the ATO and the OECD adopt the functional analysis and the separate entity approach for the purposes of profit attribution.

The determination of risk bearing is absolutely central to the OECD and ATO approach. Without it, PEs are reduced to mere service providers which is totally contrary to the OECD approach. Derivatives are the instrument by which risk is shared within the legal entity. Derivatives entered into at arm's length should be recognised in order to implement the functional analysis approach to arm's length profit attribution.
No doubt the ATO position is based on a belief that if internal derivative dealings are accepted within a fungible funding approach there is scope for an entity to determine where its profits will arise in a global context. Of course, under any functional approach whether within a single entity or between separate entities it is open to determine where risk will be initially borne and subsequently managed. So long as those decisions are driven by the business and transacted in accord with the arm's length principle no tax problem

arises. If there is an artifice constructed for tax purposes either the arm's length principle or other general or specific provisions exist to deal with any problematic tax issues. However, the purported ATO position on internal derivatives is at odds with the OECD and the ATO rulings. [As an aside, it is not clear what the status of this ATO paper is, as it is not in the form of a Ruling, and in particular whether it represents the considered view of the Commissioner.]

As previously discussed, Subdivision 815-A ITAA 1997 incorporates the AOA as it is adopted in the 2008 Commentary to Article 7 OECD MTC into Australian law. This includes all of the AOA approach to the funding of banking PEs.

***The circumstances in which a foreign currency gain or loss ought to be recognised under the AOA***

The AOA recognises internal "dealings" within the single legal entity as being analogous to legal transaction between separate entities for the purposes of applying the 1995 Transfer Pricing Guidelines to attribute an arm's length outcome to the PE. However, the recognition of the dealing is only for purposes of Article 7 and only for applying the arm's length principle.

Where there has been a "loan" from one part of the legal entity to the PE (and vice versa) recorded in the books of the PE it is accepted as being analogous to an actual transaction for purposes of pricing the loan. However, there is no actual legal transaction, and the principles espoused in Max Factor[1] continue to apply. Similarly the situation found in the Victoria Ltd[2] case where a loan is repaid in the same currency does not lead to any exchange gain or loss in $A, (at least under the AOA).

However, in circumstances in which there is a foreign currency gain or loss from transactions with third parties, that actual gain or loss can be attributed the PE either by way of tracing e.g. where the loan was for the purposes of the PE, 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.

Nothing in the AOA purports to create a foreign currency gain or loss where none exists.

***Whether granting Australian tax recognition for internal derivatives, and foreign currency gains and losses that might arise from recognition of qualifying internal dealings, may pose risks to the revenue collected from taxpayers and, if so, how those risks could be managed***

For the reasons stated above, we do not consider there to be any revenue risk in relation to profit attribution to/ from Australia, from the recognition of internal derivatives for the purposes of profit attribution, and in fact is consistent with current law.

***Other issues***

In our view, Div 230 should be amended/clarified to make it clear that AFIs can deduct interest expenses disallowed in foreign jurisdictions that represents branch capital (that is, retain the existing position as set out in para 45 of TR 2005/11).

**Q 6.3 to 6.6 - Insurers**

Insurers increasingly are using branch structures in conjunction with a centralised head office underwriting function for efficient capital management purposes. In some circumstances the branch may be required to prepare accounts which reflect the underwriting result in respect of the risks connected to the branch's jurisdiction. The taxation authorities in the branch's jurisdiction may seek to tax the branch as if it were

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[1] *Max Factor & Co v. Federal Commissioner of Taxation* (1984) 84 ATC 4060
[2] *Victoria Co Ltd v. Deputy Commissioner of Taxation* 2000 ATC 4755; (2000) 46 ATR 119

carrying on business in that jurisdiction or in the alternative, if applicable, they may be satisfied with the imposition of their equivalent Division 15.

Having regard to discussions with the industry, in our view these operating structures highlight the need for a move to tax the insurer in line with the OECD principles which would not simply have regard to where the risks are situated but to other factors such as place of underwriting activity (i.e., KERT functions).

It should also be noted that Australian reinsurers allocating reinsurance premiums to their foreign branches may have to convince insurers to not invoke Division 15 as they are not reinsuring with a non- resident but rather a foreign branch of an Australian resident reinsurer.

**Application of AOA to Insurance**

As discussed above, the 2008 Commentary to the existing Article 7 recognises the concept of economic ownership of financial assets such as insurance, and internal dealings such as risk transfers for the purposes of attributing profit according to the arm's length principle having regard to economic substance.

Under the AOA, 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. However, the AOA appropriately does not prescriptively define the particular functions of an insurance business that are the KERT functions. Instead, it provides a general definition of KERT functions, as those that are the most important active decision-making functions relevant to the assumption of insurance risk. It says that typically these fall within the category of underwriting activities, and lists such activities. In so doing, it appropriately points out that the relative importance of these activities will vary depending upon the circumstances and nature of a particular insurance business. It also recognises that other activities, e.g. product development, sales and marketing, and risk management, may, depending upon the circumstances and nature of a particular insurance business, be a part of the KERT function relating to assumption of insurance risk. Also, the AOA explicitly states that functions other than KERT functions must be attributed an arm's length reward, that there is no presumption that these other functions are by nature of low value, and that these functions may in some circumstances be appropriately rewarded with a share of the residual profit of the part of the enterprise acting as the key entrepreneurial risk-taker. 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.

In practice, the Australian Prudential Regulation Authority requires insurance companies who operate in Australia to obtain a license. As part of the licensing approval process, an insurance company including a branch of a foreign company, is required to maintain a calculated capital adequacy ratio. Ordinarily, tax practitioners have used this as the capital adequacy benchmark, and relied upon the branches' financial statements accordingly. We note that this is not an approved method under the OECD report, although the legislation does not deny the use of the OECD approved methods.

**General observations on Division 15 approach**

We consider it timely that discussions occur on whether it continues to make sense to maintain Division 15 of the Income Tax Assessment Act 1936.

Section 143 of Division 15 seeks to tax non-resident insurers in respect of insured property situated in Australia or where the insured event is one which can only happen in Australia. The insured person or their agent is obligated to remit the tax and unless this is done the insured will be denied an income tax deduction in respect of the premium.

Section 148 of the Division seeks to tax the reinsurer in circumstances where the local insurer has made an s148 election (the effect of which is the insurer is allowed to claim an income tax deduction for the reinsurance premiums and is assessed on reinsurance recoveries). An insurer who makes the election is obligated to remit the tax on behalf of the reinsurer.

Both sections ignore the source of income and seek to tax the non-residents on 10% of the premium as a proxy for the underwriting result. For non-resident insurers, however, there is an opportunity to calculate taxable income by reference to receipts and expenditure.

In our view there are good arguments that the non-resident insurer or reinsurer should be taxed on profits calculated in accordance with the established OECD principles which would not simply have regard to where the risks are situated but to other factors such as place of underwriting activity etc (see comments above regarding application of KERT principles to insurance). Moving in line with these taxation principles would obviate the need for Division 15.

The abolition of this Division is especially desirable as it can impede insurers from efficiently managing their capital due to the following:

- the reinsurance market is restricted as reinsurers are offended by the premium tax, and
- Australian insurers who use offshore captives may not obtain a Foreign Income Tax Offset for the premium tax (under Division 15) suffered on the premium paid to the offshore captive. This is particularly the case where the captive is suffering losses.

## Chapter 7 – Adopting the AOA – Administration, Compliance and Revenue Impacts

### Q. 7.1 – Obtaining comparable uncontrolled prices for qualifying internal dealings

Financial institutions such as banks have multiple desks that provide funding or hedging facilities (e.g. interest rate swaps, foreign exchange swaps, credit default swaps, etc.) to third party customers as well as to internal desks. In practice, traders are in fact commonly applying Comparable Uncontrolled Prices (CUPs) in pricing dealings with internal desks, as traders typically price internal dealings in the same way as external dealings. Further, 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 on 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.

Financial institutions often do not have viable alternatives to using CUPs in the allocating of profits to various branches. 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.

With respect to derivatives, for example, 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. While it may be possible to trace through select internal dealings could potentially be traced through, hedging is typically performed on a portfolio basis for risk management and capital efficiency reasons and hence using a "tracing through" mechanism to allocate profits to a particular desk or branch is not possible.

The "fungibility" approach often does not work either 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.

**Q7.1 Substantiation of functions, risks and use of assets**

Substantiating the split of functions, risks and use of assets between head office and PEs consistent with the AOA should not create any new administration or compliance difficulties. Under the AOA, functions are attributed based on the location of people, and risks are attributed based on the place that functions are performed relating to the assumption or management of those risks, or the place of use of a tangible asset to which those risks relate. These are factual matters amenable to relatively straight-forward substantiation. None of this is in practice any different to substantiating these matters for purposes of Australia's current PE profit attribution rules, in accordance with TR 2001/11.

Similarly, under the AOA the recognition of an internal dealing is dependent upon substantiating that a "real and identifiable event" has occurred, which again is a matter of fact essentially related to the performance of functions or the use of assets which is amenable to relatively straight-forward substantiation.

**Chapter 8 – Part IIIB, the LIBOR Cap and the AOA**

We agree with the comments in the Johnson report quoted in the Board of Taxation Discussion Paper (para 8.5). As discussed below, the Libor cap causes significant issues for inbound banks as it is often significantly lower than the actual cost of funds of the banking enterprise. The consequence of this is that some banks must weigh up the costs and benefits of electing in or out of Part IIIB in each year, with the potential for un-deducted interest costs incurred in relation to the Australian bank branch, which could impact investment decisions in relation to Australia.
There are two key issues which make the Libor cap highly problematic and not reflective of an arm's length outcome in relation to the cost of debt:

- The average term profile of bank's debt has lengthened significantly since the 2007/8 financial crisis

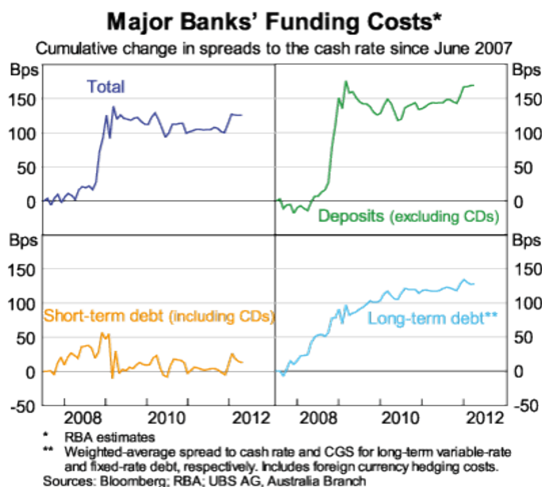
  The LIBOR is a short term rate, i.e. quoted on a 12-month basis at a maximum. In contrast, the composition funding of banks operating in Australia since 2008 has, on average, seen a significant change including less short term debt, more long term debt, and for deposit taking banks, a greater reliance on deposits as a source of funding, according to the Reserve Bank of Australia[3]

- The cost of accessing debt at all term profiles has become more expensive since the 2007/8 financial crisis.

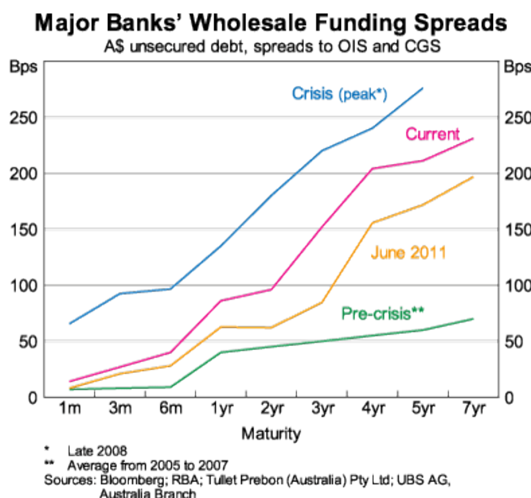
  According to the RBA, compared to mid-2007, the average cost of the major banks' funding is estimated to be about 120–130 basis points higher relative to the cash rate[4] . Most of the increase occurred during 2008 and early 2009 when the financial crisis was at its most intense. Since the middle of 2011, however, there has been a further increase in banks' funding costs relative to the

[3] http://www.rba.gov.au/speeches/2012/sp-ag-220312.html. See also Deans C and Stewart C (2012), 'Banks' Funding Costs and Lending Rates', RBA *Bulletin*, March pp 37−43
[4] As of 14 December 2012, the cash rate (3%) was approximately 70bps below the 12 month AUD Libor and equal to the overnight Libor

cash rate of the order of 20–25 basis points. The graph below shows that a fairly large part of this increase comes from the pricing of deposits.




The cost of wholesale funding has increased significantly too, compared with pre-crisis levels (see below graph).




A further problem with the Libor cap is that it applies a ‘one size fits all’ approach to banking, and does not recognise, for example that many banks trade at credit ratings below the average credit rating of the pool of banks that provide data to construct the Libor rate. A further issue relates to the fact that Libor is in fact comprised of a range of prices, and is not a single point. It also does not recognise that the funding needs (including term of funding) will vary according to the functions undertaken and business performed by the Australian bank branch.

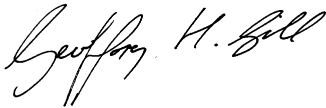
We also recognise the recent issues with the Libor itself raise questions as to the most appropriate benchmark. The Wheatley Report (2012) envisages further change to the benchmark composition, which causes further issues with its use as a cap for Australian interest deductions for Australian branches.

It is difficult to find an international reference rate to replace Libor as a cap, for the reasons set out above.

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 be 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. The arm's length principle, with its requirement to seek a reliable market benchmark for intra-entity debt arrangements, allows much greater flexibility to ensure that the debt costs attributed to Australian branches of foreign banks are not excessive having regard to the funding needs and market realities at the time of advancement of the funds.

Deloitte would be pleased to meet with you to further discuss our views and/or participate in consultation forums.

Yours sincerely



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