



Australian Government

The Board of Taxation

REVIEW OF TAX ARRANGEMENTS APPLYING TO PERMANENT ESTABLISHMENTS

Discussion Paper

the **board** of **taxation**
www.taxboard.gov.au

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FOREWORD

The Board of Taxation has been asked to examine and report on the advantages and disadvantages of Australia adopting the OECD functionally separate entity approach to the determination of the profits attributable to a permanent establishment in its tax treaty negotiations and in domestic law. This review arises from the new Article 7 (Business Profits) and commentary approved by the OECD in its 2010 Model Tax Convention on Income and on Capital, which incorporated a new authorised approach to the attribution of profits to permanent establishments.

The review is to have regard to the broad principle that profits attributed to the Australian tax base should appropriately reflect economic activity undertaken in Australia and as far as practicable the relevant rules should be aligned with and interpreted consistently with international standards.

The Board has also been asked to examine and report on the current special rule that limits the deemed interest deduction on internal funds used by foreign banks in their Australian branches to the London Interbank Offer Rate (LIBOR).

The purpose of this discussion paper is to examine the implications of Australia adopting the authorised OECD approach. To assist stakeholders the paper:

- outlines the current law and the authorised OECD approach;
- compares the current Australian approach with the authorised OECD approach;
- examines the implications of the authorised OECD approach to specific kinds of operations including banks, global trading businesses and insurance enterprises;
- examines administration, compliance and revenue impacts; and
- outlines inconsistencies between the 'deemed interest' provisions in Part IIIB of the ITAA 1936 and the authorised OECD approach.

Consultation with industry and other affected stakeholders and submissions from the public, will play an important role in shaping the Board's recommendations to the Government.

The Board has requested that submissions regarding this review be made by 14 December 2012 to enable the Board to finalise its report in the timeframe requested by Government.

Chris Jordan AO
Chair of the Board of Taxation

Annabelle Chaplain
Chair of the Working Group

CHAPTER 1: INTRODUCTION

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

1.2 The authorised OECD approach has had an uneven take-up internationally so far and the Minister has asked the Board to look at all the impacts in a considered way to assist in assessing the right policy response for Australia in this area.

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

1.4 The Board has been asked to consult extensively with stakeholders and to report to the Assistant Treasurer by 30 April 2013. Further details on the terms of reference given to the Board, including their background, are reproduced in the sections below.

BACKGROUND

1.5 In July 2010, the OECD approved a new Article 7 (Business Profits) and Commentary for the Model Tax Convention on Income and on Capital, which incorporated a new authorised approach to the attribution of profits to PEs (of which the most common example are branches).

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

1.7 Australian tax law currently allocates actual income and expenses of the taxpayer to a permanent establishment using functional analysis and applying the arm's length

principle by analogy. Australia has not made a Reservation on new Article 7¹ or an Observation on its Commentary but none of Australia's concluded tax treaties incorporate new Article 7. Tax treaties continue to be negotiated on the basis of the former OECD Model Article 7, pending final decisions on the functionally separate entity approach.

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

1.9 Policy making is complicated by the fact that countries have not universally adopted the new Article 7, or the relevant Commentary. A number of OECD countries (including New Zealand) have entered reservations to the change and the United Nations Committee of Experts on International Cooperation in Tax Matters has not viewed changes as relevant to the United Nations Model Convention. Importantly a number of key economies (Brazil, China, Hong Kong, Indonesia, Malaysia, Thailand and India) are known to have reserved their position on the new Article 7.²

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

TERMS OF REFERENCE

1.11 Against this background, the Board of Taxation was asked to examine and report on the advantages and disadvantages of Australia adopting the functionally separate entity approach to the determination of the profits attributable to a permanent establishment in its tax treaty negotiations and in the domestic law.

1 In 2005 Australia removed its former Observation on the Commentary on old Article 7. That Observation read as: Australia does not recognise intra-entity transfers for tax purposes. Accordingly, Australia does not allow a mark-up for profit on dealings between permanent establishments or between a permanent establishment and its head office.

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

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

- Overall policy objectives for cross-border profit allocation: profits attributed to the Australian tax base should appropriately reflect economic activity undertaken in Australia and as far as practicable the relevant rules should be aligned with and interpreted consistently with international standards.³
- Implications for granting relief from double tax for Australian multinational enterprises in respect of their income taxable in an offshore branch country under the new OECD Article 7.
- Evidence on the emergence of, and likely development of, the functionally separate entity approach as a new international standard. In light of this evidence, the Board might also consider the extent to which adoption of the functionally separate entity approach would:
 - affect Australian multinational enterprises in carrying on business through offshore branches in key trading and investment destinations; and
 - benefit foreign groups investing into Australia.
- Short-term and long-term impacts on taxation revenues of possible options in the context of the Government's fiscal position and strategy.
- Implications for the domestic law and for tax treaty policy of adopting the functionally separate approach and in particular whether the approach should be adopted:
 - on a treaty by treaty basis and, if so, the implications of having different rules in different treaties (and respective commentaries to follow in applying those rules);
or
 - as part of Australia's domestic law for application in all circumstances, subject to conformity with any relevant treaty.
- Whether adopting the functionally separate entity approach would bring greater certainty to stakeholders and reduce compliance and administrative costs.

³ See *Income tax: Cross Border Profit Allocation – Review of Transfer Pricing Rules*, The Treasury, 1 November 2011, paragraphs 25 – 27.

- Specific implications in the practical application of the functionally separate entity approach and for compliance with relevant methodologies including:
 - whether granting Australian tax recognition for particular intra-entity dealings that meet the requirements of the new OECD Article 7 may pose risks and how those risks could be managed. Internal derivatives and foreign currency exchange rate gains or losses are two areas that should be examined in particular;⁴
 - any special requirements for businesses both in the finance and non-finance sectors, and the corresponding implications for the administration of the law, in relation to the functional analysis and evidence required to meet the OECD standard for recognition of their intra-entity dealings.

1.13 The Board was also asked to advise what principles should be followed in amending the income tax legislation if the Government were to adopt the OECD functionally separate entity approach. In particular, this advice should cover the implications of adopting the new approach for the special rules dealing with Australian permanent establishments of foreign financial institutions.⁵ The Board's report could usefully include worked examples of how a range of intra-entity dealings in financial arrangements commonly undertaken (such as internal loans, internal derivatives and foreign exchange arrangements undertaken by financial entities) would be treated for tax purposes under the functionally separate entity approach.

LIBOR cap on intra-entity loans

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

1.15 Australia as a Financial Centre: Building on our Strengths ('the Johnson Report') noted that in periods of financial stress there can be appreciable differences between LIBOR and commercial rates for inter-bank lending. In the context of retaining this specific domestic rule, the Johnson report recommended the removal of the limitation and reliance on the usual transfer pricing rules to determine the amount of the deemed interest deduction.⁶

4 There is currently no OECD guidance that deals specifically with internal derivatives and foreign currency exchange rate gains or losses.

5 Part IIIB of the *Income Tax Assessment Act 1936*.

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

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

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

THE REVIEW TEAM

1.18 The Board has appointed a Working Group of its members comprising Annabelle Chaplain (Chair of the Working Group), Chris Jordan AO, Teresa Dyson and John Emerson AM to oversee the review. The Working Group is being assisted by members of the Board's Secretariat, the Treasury and the Australian Taxation Office (ATO).

1.19 The Board has also received assistance from Professor Richard Vann (The University of Sydney), Satyajit Das and Bob Jones as consultants and from a panel of experts comprising Ian Fullerton, Michael Johnston, Paul Hooper and Tony Frost.

REVIEW PROCESSES

Consultation

1.20 The Board has conducted targeted preliminary consultations with a range of stakeholders.

Submissions

1.21 The Board is inviting written submissions to assist with its review. Submissions should address the terms of reference set out in paragraphs 1.11 to 1.17 and the issues and questions outlined in this discussion paper (a full list of questions is at Appendix A).

1.22 The terms of reference and the principles for assessment of the functionally separate entity approach (discussed in Chapter 2) require having to consider a number of factors including, in particular:

- the Government's objectives of enhancing Australia's status as a leading regional financial centre;
- impacts on taxation revenues in the context of the Government's fiscal position and strategy;

- compliance and administrative impacts; and
- the risks that may arise in particular situations from tax recognition of intra-entity dealings and how they could be managed.

1.23 Questions in this paper are framed in light of the need to balance these considerations in a very complex area of cross border commerce and tax law relevant to Australia's tax base.

1.24 At the same time, it is not expected that each submission will necessarily address all of the questions raised in the discussion paper and, for some questions that seek feedback on particular implications or effects on businesses, stakeholders may address them only as they relate to their own business or organisation and to the extent that they are in a position to do so.

1.25 The closing date for submissions is 14 December 2012. Submissions can be sent by:

Mail to: The Board of Taxation
 c/The Treasury
 Langton Crescent
 CANBERRA ACT 2600

Facsimile: (02) 6263 2617

Email: taxboard@treasury.gov.au

1.26 Stakeholders making submissions should note that Board members, the review team, and those assisting it, will have access to all submissions. All information (including name and contact details) contained in submissions may be made available to the public on the Board's website unless it is indicated that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like only part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request for a submission to be made available under the *Freedom of Information Act 1982* (Commonwealth) that is marked 'confidential' will be determined in accordance with that Act.

The Board's report

1.27 The Board will consider the issues raised by stakeholders in their submissions and in consultation meetings. However, the Board's report and its recommendations will reflect the Board's independent judgement.

1.28 The Board has been requested to provide its report to Government by 30 April 2013.

CHAPTER 2: OVERALL POLICY OBJECTIVES AND PRINCIPLES FOR ASSESSMENT OF THE FUNCTIONALLY SEPARATE ENTITY APPROACH

OVERALL POLICY OBJECTIVES FOR CROSS-BORDER PROFIT ALLOCATION

2.1 Until recently there were two areas of law that addressed cross border transfer pricing in Australia: (a) Division 13 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) and (b) Australia's double tax treaties, typically Article 7 (which deals with business profits attributable to permanent establishments) and Article 9 (which deals with profits accruing to separate but associated entities).

2.2 On 1 November 2011, Treasury released a consultation paper on the review of the Transfer Pricing rules.⁷ As noted in the consultation paper, transfer pricing rules are designed to make sure Australia receives an appropriate share of tax from multinational firms that derive their profits across several jurisdictions. This is done by ensuring Australian tax is based on profits reflecting the economic activity attributable to Australia in accordance with the arm's length principle.⁸

2.3 The consultation paper also noted that in designing rules for cross-border profit allocation it is important to ensure that they (a) are consistent with internationally accepted transfer pricing principles and concepts and (b) do not over reach or impose transaction costs that inhibit Australia's attractiveness as a destination for new investment and business activity. Alignment with international standards would provide certainty for multinational enterprises that will benefit from rules which are consistent with the frameworks adopted by other jurisdictions.

2.4 The transfer pricing review followed the decision in *Commissioner of Taxation v SNF (Australia) Pty Ltd* (the SNF case)⁹ delivered by the Full Federal Court in June 2011.

2.5 The Federal Court in the SNF case found that the OECD's Transfer Pricing Guidelines were not a legitimate aid to the interpretation of Division 13 or the relevant treaty provisions except where evidence was led of both parties to the relevant treaty adopting the OECD guidance.

7 Income tax: cross border profit allocation - review of transfer pricing rules - consultation paper - (1 November 2011).

8 Profits attributed in accordance with the arm's length principle are profits allocated consistently with the conditions that would have operated between independent parties in comparable circumstances.

9 [2011] FCAFC 74 (1 June 2011).

2.6 The Government has announced a two phased approach to reforming Australia's transfer pricing rules to ensure that the rules give effect to the OECD's Transfer Pricing guidance:

- 1st phase: *Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No.1) 2012*, enacted on 8 September 2012:¹⁰ Confirms the separate assessment authority in accordance with the Associated Enterprises and Business Profits Articles of tax treaties. Ascertaining whether a transfer pricing benefit arises under these rules must be done consistently with 'relevant' OECD guidance. These amendments apply to income years commencing on or after 1 July 2004.

The reference to 'relevant' OECD guidance means that the new law stops short of adopting the 2010 OECD Model Tax Convention and its commentary which mandates a functionally separate entity approach to the attribution of profits to permanent establishments (as per new Article 7). This is because none of Australia's current tax treaties have been concluded on the basis of the new version of Article 7 of the 2010 OECD's Model Tax Convention; instead these treaties continue to adopt the former Article 7 approach.¹¹

- 2nd phase: a comprehensive modernisation of Division 13 that will apply going forward in treaty and non-treaty cases. This will comprise adoption of the OECD arm's length principle and ensure that Australia's rules are interpreted consistently with OECD guidance.

2.7 The Treasury's consultation paper advised at paragraph 59:

There remains a question as to whether Australia should make the necessary legislative and treaty amendments to move to a 'functionally separate entity' approach for attributing profits to a 'branch' or the 'headquarters' of a single entity, as has been adopted by the OECD. While these issues are relevant to the current reform of Australia's profit allocation rules, decisions on the treatment of permanent establishments will be treated as a separate policy question to those outlined in the remainder of this paper.

10 *Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No.1) 2012* and the Explanatory Memorandum which inserted Subdivision 815-A into the ITAA 1997 represents the first stage of transfer pricing reforms. The corresponding Bill was introduced to Parliament on 24 May 2012, passed by the Senate on 20 August 2012 and enacted on 8 September 2012. The Bill was referred to the Senate Economics Legislation Committee, with favourable findings in its *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012* report of 14 August 2012.

11 The 2010 OECD Model Tax Convention, as published, includes an annex containing the previous version of the Business Profits Article and the Commentary thereto. To the extent that a particular business profits article in any of Australia's international tax agreements aligns with this prior version of the OECD Model, the commentary contained in the annex will be relevant.

2.8 In accordance with the terms of reference, this review assesses the advantages and disadvantages of Australia adopting the functionally separate entity approach to the determination of profits attributable to a permanent establishment in its tax treaty negotiations and in the domestic law.

PRINCIPLES FOR ASSESSMENT OF THE FUNCTIONALLY SEPARATE ENTITY APPROACH

2.9 The terms of reference ask the Board to make its assessment having regard to the following:

- the commercial and other drivers for the activities undertaken by and channelled through permanent establishments;
- the type of activities undertaken by and channelled through permanent establishments (for wholesale banking and other financial services, construction services and other non-financial services, intra-entity fee-based services);
- the extent of use of permanent establishments, including the transaction volumes undertaken by them; and
- the effects of adopting the approach in terms of positioning Australia as a financial centre.

2.10 The assessment should be based on the extent to which the functionally separate entity approach:

- promotes or, at a minimum, does not impede economic and business activity in Australia;
- does not impose excessive, onerous and intrusive record keeping and other compliance requirements (while recognising that the non-existence of legal transactions between a permanent establishment and other parts of the entity of which it is a part may require certain compliance specifically for tax purposes);
- ensures a level of Australian tax generated from all activities undertaken by the relevant Australian permanent establishment that is commensurate with the economic value added by such activities;
- minimises the risk to the Australian revenue from activities including but not limited to tax arbitrage, by way of transfer pricing or by the creation of incentives to structure arrangements involving permanent establishments; and
- is able to be administered and monitored by tax authorities, both Australian and overseas, with easy access to the required information and records and without imposing excessive costs of administration.

2.11 The Board considers that the design of any rules to give effect to the functionally separate entity approach would need to recognise:

- the dynamic nature of the business and economic environment, balancing the aims of flexibility, in terms of being able to deal with changing operational conditions, with certainty of tax outcome; and
- the way the rules operate in other jurisdictions that are relevant to Australia.

Q 2.1 Issues/Questions

The Board seeks stakeholder comments on:

- reasons for using a permanent establishment rather than a subsidiary;
- the type of activities undertaken by and channelled through permanent establishments (for example, wholesale banking and other financial services, construction services and other non-financial services, intra-entity fee-based services); and
- the size or extent of use of the permanent establishments relative to any subsidiaries that particular businesses use.

CHAPTER 3: CURRENT LAW

3.1 This chapter explains how the current Australian income tax law generally applies to business operations carried on through a permanent establishment (PE) in Australia by a non-resident. It also looks at specific tax rules that apply to the Australian branch operations of foreign banks and other financial entities.

3.2 This chapter also deals with how the current tax law applies to provide relief from any double taxation of income from business operations carried on through the offshore permanent establishment of Australian residents.

NON-RESIDENTS CARRYING ON BUSINESS THROUGH A PE IN AUSTRALIA

3.3 For non-residents carrying on business through a PE in Australia, the taxpayer's liability to Australian tax is affected by whether or not a tax treaty applies.

3.4 If no tax treaty applies, Australia taxes all of the non-resident's Australian source income after allowing relevant deductions except that interest, dividends, MIT fund payments¹² and royalties derived by the non-resident (otherwise than through the non-resident's Australian PE for interest and dividends) are generally subject to a final withholding tax. Where a tax treaty applies, business profits of the entity and its PE are subject to:

- the Business Profits Article in the relevant treaty;¹³ and
- subsections 3(2)¹⁴ and 4(2)¹⁵ of the *International Tax Agreements Act 1953* (ITAA 1953).

3.5 For the purpose of calculating the relevant Australian source income of a non-resident that will be subject to Australian tax, the Commissioner can make a determination that income derived or expenditure that is incurred is attributable to activities carried on by the taxpayer at or through the PE.¹⁶ The provisions allow the

12 Managed investment trusts fund payments.

13 Australia's tax treaties are given the force of law by section 5 and other sections of the *International Tax Agreements Act 1953*.

14 Subsection 3(2) of the *International Tax Agreements Act 1953* provides that the reference to 'profits' in the branch profits article is generally a reference to 'taxable income derived from' the branch operations for the purpose of Australian tax law (unless the context requires otherwise).

15 Subsection 4(2) of the *International Tax Agreements Act 1953* provides that the provisions of that Act (including the provisions of Australia's tax treaties) apply notwithstanding anything inconsistent contained in any Australian tax legislation (other than Part IVA of the *Income Tax Assessment Act 1936*).

16 Subsections 136AE(4) to (7) of the ITAA 1936.

Commissioner to assess more income than reported by the taxpayer, and to deny a claim for a deduction, where a functional analysis of the operations of the PE indicates that the amount reported by the taxpayer understates the amount on which tax is payable in Australia. The provisions apply regardless of whether or not a treaty applies, but where a treaty applies the provisions must not increase taxable profits beyond the level permitted by the treaty. Where tax treaties apply, Subdivision 815-A confirms that the relevant articles of the treaty are able to be applied independently of Division 13 (which contains subsections 136AE(4) to (7)) through explicit incorporation into the *Income Tax Assessment Act 1997* (ITAA 1997).

3.6 Key aspects of the provisions that affect the attribution of profits or income and expenses to an Australian PE of a non-resident are summarised below:

Treaty Business Profits article and subsection 3(2) of the ITAA 1953	Section 136AE(4) to (7) of ITAA 1936
Profits attributable to (taxable income derived from the operations of) a PE situated in Australia (or a PE in the other country) are taxable in Australia (or in the other country); otherwise the country of residence has the sole right to tax a resident enterprise's income.	Allows the Commissioner to determine that income that is attributable to a PE is sourced from Australia or outside Australia and the expenses that are attributable to a PE are incurred in earning income that has an Australian source or a source outside Australia.
Only actual income and expenses are taken into account in determining profits attributed to (that is, taxable income from) PE operations.	Same
Self-executing (unless a treaty provision allowing recourse to domestic tax law is operative) ¹⁷	Needs Commissioner's determination. Can only be used where the taxpayer's return showed 'a tax result more favourable to the taxpayer'.
Attributes profit (taxable income) as though the PE was a 'distinct and separate enterprise' dealing at arm's length with the enterprise of which it is a PE or with other enterprises.	Same principle taken into account in making the determination.

3.7 In determining the amounts attributable to PE operations, a functional analysis is undertaken. This involves examining, as if the PE is a distinct and separate enterprise:

1. the economically significant activities or functions actually undertaken by the PE (including their nature and frequency) and the rest of the enterprise;
2. the risks thereby assumed as a result of the PE's functions; and
3. the assets (both tangible and intangible) used by the PE and the nature and extent of that use.

The above are then compared to the functions performed, risks assumed and assets used by the enterprise as a whole in order to arrive at an allocation.

¹⁷ For example, refer to paragraph 4 of Article 7 of the Australia - UK treaty.

RESIDENTS CARRYING ON BUSINESS THROUGH A PE IN ANOTHER JURISDICTION

3.8 Australia relieves any potential double taxation of the income of Australian taxpayers with overseas PEs by giving an exemption for income attributed to the PE in particular circumstances;¹⁸ and giving a foreign income tax offset (credit) against Australian tax for foreign income tax on profits/income of the PE where the exemption does not apply.¹⁹

3.9 The exemption essentially applies to the income that would otherwise have been assessable in Australia. The other relevant country may use different principles to determine the tax base for the profit calculation taxable in that country. This means that the amount brought to tax in the offshore jurisdiction will not necessarily be the same as the amount to which the Australian exemption mechanism may apply.

SPECIAL PROVISIONS APPLICABLE TO THE FINANCIAL SECTOR

3.10 In addition to the above, there are two other provisions that are relevant to the financial sector:

- For an entity (Australian resident or not) that is a 'registered Offshore Banking Unit (OBU)' and carries on qualifying 'Offshore Banking Activities (OB activities)' at or through its Australian branch operations – these activities are taxed at a concessional effective rate of 10 per cent.
- In order to recognise certain specific notional transactions between a foreign financial institution and its Australian branch, Part IIIB of the ITAA 1936 treats the Australian branch as a functionally separate entity in certain respects.

3.11 The OBU provisions provide that the Australian branch carrying on qualifying OB activities and the entity's other overseas branches are treated as different persons for the purposes of determining if there are qualifying OB activities, including as this affects the application of Division 230 (taxation of financial arrangements).²⁰

3.12 Part IIIB provides particular treatment to foreign banks and qualifying financial institutions with Australian branch operations with respect to the measurement of their cost of funds used in their Australian branch operations. Financial institutions are able to elect out of Part IIIB if their taxable income would be lower than if Part IIIB did not apply.²¹

18 Principally under section 23AH of the ITAA 1936, which treats relevant income as non-assessable non-exempt income, and has the effect of excluding the relevant income from Australian taxable income.

19 Division 770 of ITAA 1997.

20 Section 121EB of ITAA 1936.

21 Section 160ZZVB of ITAA 1936.

3.13 The 'deemed interest' provisions in Part IIIB (sections 160ZZZ, 160ZZZA and 160ZZZJ) were introduced to recognise the difficulty in precisely measuring a foreign bank's cost of funds for its genuinely mixed debt and equity funds that are used in its Australian branch operations (per Banking Policy Statement by then Treasurer Hon. John Dawkins in 1993). Consequently, foreign banks are able to apply Part IIIB which:

- deems 100 per cent of the 'funds made available by a foreign bank for use' in its Australian bank branch operations to be 'borrowings' by the branch;²²
- deems the amount 'entered in the branch's accounting records' in relation to the funds made available to be interest incurred and paid by the Australian branch (and thereby effectively deductible under section 8-1 of the ITAA 1997);
- caps the above deemed interest deduction to the applicable LIBOR rate for the currency of the funds provided;
- applies withholding tax on the above deemed interest at half the usual withholding tax rate (that is, at 5 per cent instead of 10 per cent).²³

3.14 Part IIIB also allows amounts recorded as paid or received in respect of an internally recorded derivative transaction (relating to interest rate risk or exchange rate risk) or a foreign exchange transaction covered by the provision and 'notionally entered into' with the bank by the Australian branch in carrying out its banking business to be recognised for income tax purposes (sections 160ZZZE and 160ZZZF). Such deemed payments or receipts are then subject to the usual tax rules, such as the general deduction rules, that apply to actual payments or receipts.

22 Although the design of the comprehensive thin capitalisation provisions introduced in 2001 by way of Division 820 of the ITAA 1997 is that this is subject to an equity capital requirement. Section 160ZZZD, repealed in 2001 as a consequence of the enactment of the new thin capitalisation provisions in Division 820, had operated so that the amount of the deemed interest under section 160ZZZA was 96 per cent of the 'funds made available by a foreign bank for use' in its Australian branch operations. Consistent with this, the Explanatory Memorandum to New Business Tax System (Thin Capitalisation) Bill 2001 states:

Foreign bank branches

4.53 The notional equity requirement [in former 160ZZZD] is to be replaced by the provisions in the new thin capitalisation regime dealing with foreign bank branches in Australia. Hence, the notional equity requirement will be repealed. Other minor consequential amendments are made as a result of the repeal of the notional equity requirement. [Schedule 1, items 6 to 9].

23 This withholding tax applies irrespective of whether Part IIIB or the treaty applies to determine the taxable income of the branch.

CHAPTER 4: THE AUTHORISED OECD APPROACH

INTRODUCTION

4.1 The 2010 OECD Report released on 22 July 2010 discusses the authorised OECD approach otherwise known as the ‘functionally separate entity’ approach in detail (Part I of the Report deals with the general approach, Part II deals with banks, Part III deals with global trading and Part IV deals with insurance). The release of this Report was accompanied by:

- a new version of Article 7 of the OECD’s Model Tax Convention; and
- a replacement Commentary to the OECD Model Tax Convention Article 7 to reflect the authorised OECD approach (‘2010 OECD Model Commentary on Article 7’).

4.2 A copy of the new version of Article 7 of the Model Tax Convention (and of the former Article 7) is provided at Appendix B as further reference.

4.3 The new Commentary states that the new Model Article 7 ‘must be interpreted in light of the guidance contained’ in the 2010 OECD Report.

AUTHORISED OECD APPROACH — GENERAL PRINCIPLES

4.4 The authorised OECD approach applies the arm’s length principle relevant to separate but associated enterprises²⁴ to determine the amounts attributable to a PE in its dealings with the rest of the enterprise of which it is a part. To do this, the authorised OECD approach hypothesises the PE as a separate enterprise engaged in the same or similar activities under the same or similar conditions, taking into account functions performed, assets used and risks assumed by the PE (par 9).²⁵

4.5 The authorised OECD approach recognises that a PE is not legally separate from the enterprise of which it is a part and that this legal reality has economic consequences. For example, the authorised OECD approach recognises that generally a PE has the same creditworthiness as the rest of the enterprise (same creditworthiness principle – par 30)²⁶ and that a PE cannot contract with the enterprise of which it is a part. This could mean, for example, that a financial transaction (such as a loan, a

24 Contained in the OECD’s *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010).

25 All references are to the 2010 OECD Report Part I unless otherwise stated. Paragraph references are to the version of the 2010 OECD Report available on the OECD website at: <http://www.oecd.org/tax/transferpricing/45689524.pdf>.

26 The same creditworthiness principle implies that no risk premium could be charged in the price for dealings between the PE and the rest of the enterprise of which it is a part (Part II, par 28).

derivative or a guarantee of a financial transaction) between a PE and a third party that is otherwise identical to an internal dealing between the PE and another part of the enterprise of which it is a part, may incorporate into the price an element of credit risk that does not exist in the internal dealing.

4.6 In applying the functionally separate entity approach to a PE, the authorised OECD approach focuses on what the PE actually does (that is the functions performed by the branch). This then determines the assets that the PE 'owns' (assets follows function principle – par 15) and the risks that the PE assumes (risks follows functions principle – par 15).

4.7 The dealings arising from the functions, assets and risks attributable to the PE are then priced as if the PE were a separate and independent enterprise dealing at arm's length with the rest of the enterprise – that is, the price 'charged' for the dealing is commensurate with what an independent party dealing at arm's length would charge (par 42). Broadly, the term 'dealings' is used to describe the PE's interactions with the rest of the enterprise of which it is part which are not legal transactions but which the 2010 OECD Report refers to as the equivalent of separate enterprise transactions. This means:

- the price can be more than cost recovery (as expected for a separate viable business enterprise) although it does not have to be (par 42);
- a PE may have profits attributed to it even though the enterprise as a whole has not made profits in a particular period (2010 OECD Model Commentary on Article 7 par 17);²⁷
- a PE may not have profits attributed to it even though the enterprise as a whole has made profits in a particular period (2010 OECD Model Commentary on Article 7 par 17).

4.8 The authorised OECD approach is summarised in the 2010 OECD Model Commentary on Article 7 as involving two steps:

21. Under the first step, a functional and factual analysis is undertaken which will lead to:

–the attribution to the permanent establishment, as appropriate, of the rights and obligations arising out of transactions between the enterprise of which the permanent establishment is a part and separate enterprises;

–the identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the permanent establishment;

²⁷ Australia's current law also allows for this result. For example, this could be where a higher proportion of overall gross income than expenses is attributed to branch operations.

- the identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the permanent establishment;
- the identification of other functions of the permanent establishment;
- the recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test referred to in paragraph 26; and
- the attribution of capital based on the assets and risks attributed to the permanent establishment.

22. Under the second step, any transactions with associated enterprises attributed to the permanent establishment are priced in accordance with the guidance of the OECD Transfer Pricing Guidelines and these Guidelines are applied by analogy to dealings between the permanent establishment and the other parts of the enterprise of which it is a part. The process involves the pricing on an arm's length basis of these recognised dealings through:

- the determination of comparability between the dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the permanent establishment; and
- the application by analogy of one of the Guidelines' methods to arrive at an arm's length compensation for the dealings between the permanent establishment and the other parts of the enterprise, taking into account the functions performed by and the assets and risks attributed to the permanent establishment and the other parts of the enterprise.

4.9 Part I of the 2010 OECD Report discusses general principles which apply to all industries, including:

- functional and factual analysis;
- attribution of assets;
- attribution of risks;
- attribution of free capital (and interest cost); and
- recognition of dealings.

Functional and factual analysis

4.10 The authorised OECD approach attributes to the PE those risks for which the significant functions relevant to the assumption and/or management of risks are performed by people in the PE. It also attributes to the PE economic ownership of

assets (other than tangible assets, see 4.12 below) for which the significant functions relevant to the economic ownership of assets are performed by people in the PE (par 15).

4.11 In the case of financial assets of financial enterprises, the same significant people functions will generally be relevant both to the assumption of risk and to the economic ownership of those assets. Outside the financial sector, risk may be less intimately linked with assets, so that there may be less overlap between the significant people functions relevant to the assumption of risk and those relevant to the economic ownership of assets (par 16).

Attribution of assets

4.12 Assets are initially attributed to the part of the enterprise as follows:

- For tangible assets – where the assets are used (par 18; par 75). Functional and factual analysis may justify a different view – for example, in a cost contribution arrangement (par 75; par 197).
- For intangible assets – where the decision to take on the risk associated with the intangible assets was made. The 2010 OECD Report discussed three intangibles which are summarised in the table below.

Intangible type	Where initial economic ownership lies
Internally created intangibles	The active decision-making and relevant management decisions; not just simply saying yes or no to a proposal (par 87). For example, design and test the specifications for the research, review and evaluate the data produced by the test, set parameters whether to proceed further, decide whether to proceed or abandon (par 88).
Acquired intangibles	The active decision-making in taking on and managing risks. For example, evaluate acquired intangible, perform follow-on development activity, evaluate and manage risks related to deploying the asset (par 94).
Marketing intangibles (for example, brand, logo)	The initial assumption and subsequent relevant management of risks of marketing intangibles. For example, creating and control of branding strategies and trademark protection, maintenance of established marketing intangibles (par 97).

Attribution of risks

4.13 Under the authorised OECD approach it is possible to treat the PE as assuming risk, even though legally the enterprise as a whole assumes the risk and there can be no legally binding contractual arrangements allocating that risk to a particular part of the enterprise. The PE should be considered as assuming any risks for which the significant people functions relevant to the assumption of risk are performed by the personnel of the PE at the PE's location (par 68).

4.14 A risk may be considered to be transferred to another part of the enterprise if there is documentation evidencing the intention to engage in a 'dealing' in the form of a transfer of the risk to that other part, and that other part thereafter performs the

significant people functions relevant to the management of the risk. However, documentation by itself would not effect such a transfer since a part of the enterprise which has not initially assumed a risk cannot be deemed to have subsequently taken over the risk unless it is also managing the risk. In this sense, risk cannot be separated from function under the authorised OECD approach (par 70). For risks associated with financial assets, refer to the discussion of the specific rules applying to banks in paragraphs 6.5 to 6.12 of this Discussion Paper.

Capital (and interest cost) attribution

4.15 Under the authorised OECD approach, the functional and factual analysis dictates the amount of capital (debt²⁸ and free capital)²⁹ allocated to the PE, the idea being that a separate enterprise carrying out the same operations as the PE would need capital to support the risks assumed and the assets owned by it (par 107).

4.16 The authorised OECD approach allocates free capital to PEs under a two stage process (par 107):

- First, from the functions performed by the PE, it is determined what risks are assumed by, and what assets 'belong' to, the PE. The assets can be valued at cost, book value or market value (par 107 to 114).
- Second, the free capital needed to support the functions, assets and risks attributed to the PE is determined. This process takes into account the PE's functions, assets and risks as part of the enterprise's overall functions, assets and risks because different business activities require different amounts of free capital (par 117).

4.17 The major factors influencing the arm's length amounts of free capital and debt capital attributable to the PE are (par 130):

- the capital structure of the enterprise as a whole (typically considered to be at arm's length unless the enterprise itself is thinly capitalised); and
- actual capital structures of an enterprise doing the same things as the PE under similar conditions (bearing in mind the same creditworthiness principle).

28 The authorised OECD approach accepts that what is 'debt' should be governed by reference to a branch country's domestic law (2010 OECD Report par 118).

29 The concept of free capital refers to equity capital which does not give rise to amounts that are deductible for tax purposes under the rules of the host country of the PE.

4.18 The following four approaches to attributing free capital to branch operations are discussed in the 2010 OECD Report:

Approaches	Discussion
<p>Actual capital allocation approach — that is allocate the enterprise's actual free capital to the PE based on the branch operations' portion of the enterprise's overall assets and risks (par 121).</p>	<p>If the PE's operations are a very different business to the rest of the enterprise then this must be accounted for, if not already factored into the functional analysis (par 124).</p> <p>In the case of non-financial institutions, there are practical difficulties in producing a meaningfully narrow range of acceptable outcomes, even after determining the creditworthiness (par 127).</p> <p>If the enterprise is itself too thinly capitalised, then either:</p> <ul style="list-style-type: none"> • directly adjust the free capital attributable to the PE to an arm's length amount based on what an independent enterprise carrying out the branch operations would have (par 142); or • adjust the actual free capital of the enterprise to an arm's length amount first, and then attribute a portion of the adjusted amount to the PE (par 143).
<p>Economic capital allocation approach — that is allocate free capital based on risks (par 128)</p>	<p>Risks are difficult to quantify especially for non-financial operations.</p>
<p>Thin capitalisation approach³⁰ — that is, determine the free capital that an independent enterprise carrying out the operations of the PE in the same jurisdiction would have but subject to the same creditworthiness principle (par 129).</p>	<p>Issues arise in seeking to apply a thin capitalisation approach to non-financial enterprises (par 131). In practice, there will be a wide range of debt to equity ratios. The factors underlying the differences should be investigated. Any differences due to shareholder risk appetite will be reduced due to the same creditworthiness principle (par 132).</p> <p>A weakness in this approach is that the sum of the free capital allocated to the enterprise's PE may be more than the total free capital in the enterprise (par 134).</p>
<p>Safe harbour — quasi thin capitalisation /regulatory minimum capital approach (for regulated banks).</p> <p>Attribute free capital to the PE to the minimum level that an independent enterprise conducting those operations would have.</p>	<p>This approach does not meet the requirements of the authorised OECD approach as it is not consistent with the same creditworthiness principle (par 135).</p> <p>It may be acceptable as a safe harbour provided it does not attribute more profit to the PE than under the authorised OECD approach (par 135).</p> <p>This approach is difficult to apply for entities outside the regulated financial services sector.</p>

4.19 The 2010 OECD Report notes that while there is international consensus on the principle that the PE should have sufficient free capital to support the functions, assets and risks attributed to the PE, it is not possible to develop a single internationally accepted approach for attributing the necessary free capital (par 147).

30 The OECD uses the term thin capitalisation in a different sense to that in Division 820 of Australia's tax law. The OECD's use of the term is outlined in the table.

4.20 Once capital is allocated, interest expense on debt attributed to the PE can be determined using the following approaches, provided the result complies with the arm's length principle (par 156).³¹

- Tracing approach – internal movement of funds is traced back to the original provision of those funds by third parties. The interest rate on the funds given to the PE is the same as the actual third party costs (par 154).
- Fungibility approach – money borrowed by the enterprise is treated as contributing to the whole enterprise's funding needs and not to particular funding needs. The PE is allocated a portion of the whole enterprise's actual interest expense on a pre-determined basis. There's no need to recognise any internal interest dealing (par 154) under this approach.

4.21 If there are qualifying internal dealings as set out in paragraphs 4.23 to 4.27 below, the qualifying internal dealings can be recognised as treasury dealings³² only if it is possible to conclude that other operations of the enterprise have undertaken the significant people functions relevant to determining economic ownership of the funds used in the enterprise's PE and should be entitled to an 'arm's length return' for the funds (par 153). If a qualifying internal dealing is recognised as a treasury dealing it should be priced on an arm's length basis (refer to paragraph 6.23 of this Discussion Paper for what constitutes the arm's length amount for such treasury dealings).

4.22 If those other operations of the enterprise simply borrow and immediately 'on-lend' to the PE this will likely be a 'conduit' scenario compensated by a service fee, in addition to the actual interest cost (par 159). The same would be true for funds obtained by the PE from third parties and provided to other operations of the enterprise.

Qualifying internal dealings

4.23 Dealings between a PE and the rest of the enterprise have no legal consequences for the enterprise as a whole, so there is a need for greater scrutiny of internal dealings. The factual and functional analysis must reveal that a real and identifiable event has occurred that is economically significant enough to constitute a qualifying internal dealing (par 35 and par 175 to 182).

4.24 It is the functional and factual analysis that determines whether the relevant dealing has taken place, not the accounting records or other documentation provided by the enterprise (par 177). There are no 'contractual terms' to analyse; rights and

31 A number of approaches are noted at paragraph 156 as authorised under the authorised OECD approach as long as the amount of interest expense claimed by the PE does not exceed an arm's length amount and that any treasury functions are appropriately rewarded. Chapter 6 deals with these issues in more detail as applied for banks.

32 As noted in this paragraph, for a 'treasury dealing' to be recognised as such, the economic ownership of the funds used by the PE should be attributed to another operation of the enterprise that would be entitled to receive an 'arm's length return' for the funds used by the PE. See paragraphs 6.21 to 6.23 of this Discussion Paper for a further discussion of treasury dealings.

obligations do not arise from documentation. This is not to say that documentation is irrelevant for the purposes of applying the functionally separate entity approach. The 2010 OECD Report states that ‘... the starting point for the evaluation of a potential ‘dealing’ will normally be the accounting records and internal documentation of the PE showing the purported existence of such a “dealing”.’ (par 177) Taxpayers are encouraged by the Report to prepare such documentation (par 181).

4.25 At the same time, it is the conduct of persons undertaking functions in the course of the PE operations and the conduct of persons performing functions in the course of the enterprise’s other operations that are capable of giving rise to a qualifying internal dealing (par 179; par 180). The functional and factual analysis, together with the OECD transfer pricing guidelines, involves an examination of whether the conduct of the parties conforms to the terms of the dealing, an analysis that is particularly important in the PE context where those terms between the various parts of the enterprise are not contractually binding (par 180).

4.26 Further, as internal dealings do not give rise to rights or obligations, it is recognised that such dealings require greater scrutiny than dealings between associated enterprises, and countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the relevant dealing (par 175). Internal documents will be recognised as evidence of an internal dealing only when the following threshold is met (par 36; par 181):

- the documentation is consistent with the economic substance of the activities taking place in the enterprise as revealed by functional and factual analysis;
- the dealing is one which independent enterprises would enter into; and
- the dealing does not violate the principles of the authorised OECD approach, for example, transferring risks in a way that separates them from functions.

4.27 It is also important to note, however, that the authorised OECD approach is generally not intended to impose more burdensome requirements in connection with intra-enterprise dealings than apply to transactions between associated enterprises (par 37).

Situations where assets can be ‘internally transferred’

4.28 Assets initially attributed to a part of an enterprise can at a later time be attributed to another part of the enterprise:

- For tangible assets – when the place of relevant ‘use’ changes, in which case there will be a transfer at market value with implications for tax depreciation (par 196) and whether a gain or loss is made on the transfer. If, in special circumstances, economic ownership for tangible assets is not based on use and there is no economic transfer of the asset then the physical relocation of the asset will not entail a profit (or loss) but be treated like a lease or licensing arrangement (par 199).

- For intangible assets – when the location of the relevant active decision-making changes, in which case an arm’s length return to the initial owner must be determined. The arm’s length return to the initial owner can be in the form of (a) a market value sale price (with flow-on consequences for amortisation deductions), (b) an ongoing share in overall profit or (c) a royalty for the use of the intangible (par 203). The authorised OECD Approach recognises all three outcomes as potentially applicable depending on the particular circumstances.³³

How internal services are to be dealt with

4.29 In the case of internal services, the functional and factual analysis will reveal if both parties would have contracted for the provision of the service if they had acted at arm’s length and, if so, what is the arm’s length price for the service. The arm’s length price may be above or below the actual cost of providing the service (par 218). Sometimes the branch operations and the other parts of the enterprise can act as economic co-participants in a cost-contribution type activity (CCA). Provided the threshold for a CCA is met, services may be appropriately rewarded by just allocating costs (par 220).

Notional income under the separate enterprise hypothesis

4.30 If an amount is charged for a qualifying internal dealing, paragraph 28 of the 2010 OECD Model Commentary on Article 7 states that:

28. The separate and independent enterprise fiction that is mandated by paragraph 2 [of Article 7] is restricted to the determination of the profits that are attributable to a permanent establishment. It does not extend to create notional income for the enterprise which a Contracting State could tax as such under its domestic law by arguing that such income is covered by another Article of the Convention which, in accordance with paragraph 4 of Article 7, allows taxation of that income notwithstanding paragraph 1 of Article 7 ...

4.31 The Commentary in paragraph 29 goes on to suggest that if a country wishes to charge taxes on such deemed income then it should expressly so provide in tax treaties. Alternatively the country may wish to provide in its tax treaties that internal dealings of this kind will not be recognised in calculating profits attributable to the PE.

29. Some States consider that, as a matter of policy, the separate and independent enterprise fiction that is mandated by paragraph 2 [of Article 7] should not be restricted to the application of Articles 7, 23A and 23B but should also extend to the interpretation and application of other Articles’ of the Convention, so as to ensure that permanent establishments are, as far as possible, treated in the same way as subsidiaries. These States may therefore consider that notional charges for dealings which, pursuant to paragraph 2, are deducted in computing profits of a permanent establishment should be treated, for the purpose of other Articles of the Convention, in the same way as payments that would be made by a subsidiary to its parent company. These States may therefore

33 Current OECD work on taxation of intangibles may have an impact in this area.

wish to include in their tax treaties provisions according to which charges for internal dealings should be recognised for the purposes of Articles 6 and 11 (it should be noted, however, that tax will be levied in accordance with such provisions only to the extent provided for under domestic law). Alternatively, these States may wish to provide that no internal dealings will be recognised in circumstances where an equivalent transaction between two separate enterprises would give rise to income covered by Article 6 or 11 (in that case, however, it will be important to ensure that an appropriate share of the expenses related to what would otherwise have been recognised as a dealing be attributed to the relevant part of the enterprise). States considering these alternatives should, however, take account of the fact that, due to special considerations applicable to internal interest charges between different parts of a financial enterprise (for example, a bank), dealings resulting in such charges have long been recognised, even before the adoption of the present version of the Article.

INTERNATIONAL DEVELOPMENTS

4.32 The United Nations Committee of Experts on International Cooperation in Tax Matters has rejected the authorised OECD approach in its Model Double Taxation Convention between Developed and Developing Countries:

The Committee of Experts decided not to adopt this OECD approach because it was in direct conflict with paragraph 3 of Article 7 of the United Nations Model Convention which generally disallows deductions for amounts ‘paid’ (other than toward reimbursement of actual expenses) by a permanent establishment to its head office.³⁴

4.33 As indicated in the reservations of member countries and positions on non-member countries on the OECD Model, the following jurisdictions do not support and have expressly reserved³⁵ their position on adopting the OECD Model new Article 7: Argentina, Brazil, Chile, Greece, Hong Kong, India, Indonesia, Latvia, Malaysia, Mexico, New Zealand, the People’s Republic of China, Romania, Serbia, South Africa, Thailand and Turkey (of which Chile, Greece, Mexico, New Zealand and Turkey are OECD members). Portugal also reserved its right to continue to adopt the previous version of the OECD Model Article 7 text until its domestic law is adapted in order to apply the new approach.

4.34 With a significant number of countries having signalled they either do not intend to adopt the new Article 7 in their bilateral tax treaties or are not yet in a position to do so, it may be expected that only new tax treaties between two countries that have both chosen to adopt new Article 7 will include the new Article 7 (although this would be subject to what countries may decide to negotiate on a bilateral basis). Consequently, only a limited number of recently concluded treaties adopt the new Article 7. These

³⁴ At paragraph 1 of the 2011 Commentary to UN Model Article 7.

³⁵ These countries have reserved their position, which preserves their rights to act differently.

include the 2012 Germany-Luxembourg, 2012 Germany-Netherlands, 2012 United Kingdom-Barbados and 2012 United Kingdom-Liechtenstein tax treaties.

4.35 In addition, Canada and the United States announced in July 2012 that their competent authorities have agreed that the business profits Article of the 2007 Canada-United States income tax treaty will be interpreted in a manner entirely consistent with the full authorised OECD approach as set out in the 2010 OECD Report.³⁶ The US had also publicly taken the position that the authorised OECD approach was incorporated in the 2001 US-UK treaty, and in the 2003 US-Japan treaty.³⁷

4.36 It is normal for model tax treaty innovations to take some time to be adopted in actual treaties for a number of reasons. First, treaties can take several years to negotiate and sign and hence negotiation of Article 7 in recent treaties may have been finalised before the new Article 7 was adopted by the OECD. Second, it takes some time for countries to consider their position on treaty innovations.

4.37 Nevertheless, the Board understands from the Treasury that several of Australia's existing tax treaty partner countries (including Canada, Germany, the Netherlands, Switzerland, the United Kingdom and the United States) may seek to adopt new Article 7 in their future tax treaties.

Q 4.1 Issues/Questions

The Board seeks stakeholder comments on:

- whether there are other countries which are likely to adopt the new Article 7 in their bilateral tax treaties;
- whether there are reasons other than those given by the United Nations Committee of Experts (see paragraph 4.32) for certain countries not adopting the new Article 7 in their bilateral tax treaties; and
- whether there are any examples of inconsistent application between domestic tax law and tax treaty policy in countries adopting the new Article 7.

36 <http://www.cra-arc.gc.ca/tx/nnrdsnts/ntcs/cndntdstts-cmptntgrmt-2012-eng.html>.

37 The U.S. Treasury issued a statement as follows:

'While we fully support the Authorised OECD Approach (AOA) for attributing profits to a permanent establishment (PE), it will not apply to most existing U.S. tax treaties. We generally provide in Article 7(3) [of most existing U.S. tax treaties] for a 'reasonable allocation' of certain expenses, which is not consistent with the arm's-length approach of the AOA.

We have, however, specifically incorporated the AOA in a few (for example, U.K. and Japan) recent treaties and it is now in the 2006 U.S. Model Income Tax Convention.' (see 'Treasury Releases Statement on PE Attribution of Profits,' 7 June 2007: 2007 Tax Notes Today 112-53).

CHAPTER 5: ADOPTING THE AUTHORISED OECD APPROACH IN AUSTRALIA

5.1 This chapter raises issues that may require consideration if the authorised OECD approach were to be adopted in Australia. The issues fall into two categories:

- those existing tax rules which would need to interact with the approach; and
- whether the approach should lead to some reconsideration of existing tax settings.

5.2 The second category is particularly relevant because various issues and questions (see, in particular, paragraphs 5.12 – 5.14 below) arise from the idea of treating a PE as a functionally separate entity. These issues and questions extend beyond the attribution of profits to PEs under tax treaties.

5.3 As discussed in Chapter 3, Australia determines the profit attributable to a PE by separately allocating actual income and expenses from external transactions using functional analysis. No internal ‘mark-up’ is recognised on ‘internal dealings’ and no internal ‘income’ is allocated to the PE.³⁸

Interactions with existing provisions of the income tax law

5.4 Broadly speaking, the traditional position under the income tax law is that a legal entity recognises taxable gains and losses from transactions with third parties and not from dealings between different parts of that entity. This position is subject to the operation of specific provisions of the income tax law.

38 However, paragraph 5.16 of Taxation Ruling 2001/11 refers to the recognition of internal trading stock transfers on the basis of accounts prepared for the PE on a separate entity basis (provided that they have been properly prepared and the attribution outcomes are the best estimate of PE profits that can be made in the circumstances).

5.5 The table below sets out current specific tax rules for particular kinds of non-financial assets transferred from one entity to another entity or put to relevantly different use within the same entity:

Asset type	Transfer (from one entity to another entity)	Change in use (within the same entity)
Trading stock	Assessable as ordinary income	Trading stock → non-trading stock: Deemed disposal at cost (s70-110). Non-trading stock → trading stock: Deemed disposal and reacquisition at cost or market value (elect): s70-30. CGT Event K4 applies if elect market value.
Depreciating asset	Balancing adjustment event	Taxable purpose → non-taxable purpose (for example, earning s.23AH exempt income): <ul style="list-style-type: none"> - No deduction for decline in value for non-taxable purpose. - CGT Event K7 relevant on eventual disposal. Non-taxable purpose → taxable purpose: Decline in value starts when asset first used for any purpose. Deduction for taxable purpose use: s40-60 Taxable purpose → another taxable purpose: no consequence.
CGT asset	CGT event	No consequence (however, if an asset commences to be used in the Australian branch operations of a non-resident, it will become 'taxable Australian property' — s855-15). Eventual capital gain maybe reduced to the extent it is made non-assessable non-exempt by a provision: s118-20(4) or based on a time apportionment comparing time of use in an Australian branch and time of use not in an Australian branch: s 855-35.

5.6 If the above assets, or transactions in respect of the above assets, are denominated in foreign currency, the following rules affecting taxation of foreign currency gains or losses will apply:

	Principles
Case law	Foreign exchange gains or losses are brought to account when realised in accordance with general income tax principles; foreign exchange gains and losses are not recognised on internal dealings between a PE and the rest of the enterprise (Max Factor v FCT 84 ATC 4060). The tax treatment of foreign exchange gains and losses follows the tax treatment of the receipts or payments to which they relate: Commercial and General Acceptance v FCT (1977) 137 CLR 373; AVCO Financial Services v FCT 82 ATC 4246.
Division 775	Brings into account foreign exchange gains and losses if a 'forex realisation event' occurs in relation to foreign currency or 'a right to receive or pay foreign currency' or 'an obligation to pay or receive foreign currency'
Sub-divisions 960-C and D	Provides rules to translate assets, liabilities, expenses and revenue denominated in foreign currency to Australian dollars (or to a functional currency, with ultimate translation to Australian dollars) for Australian tax purposes.

5.7 With respect to interest withholding tax (IWT), it should be noted that in response to recommendations in the Johnson report and in the Australia's Future Tax System Review, the Government announced in the 2010-11 Budget that, as a measure to support banking competition, it would phase down the rate of IWT for financial institutions from 2013-14. Subsequent to this, in November 2011 the Government announced, as a savings measure, a one-year deferral of the IWT phase down due to changes in the fiscal circumstances because of global economic events. As per the then Assistant Treasurer's media release of 23 November 2011, the one-year deferral means that:

- the rate of IWT for foreign bank branches which borrow from their overseas head office will fall from 5 per cent to 2.5 per cent in 2014-15, and to zero in 2015-16; and
- the rate of IWT for other financial institutions which borrow from foreign financial institutions, and financial institutions which borrow in offshore retail markets, will fall from 10 per cent to 7.5 per cent in 2014-15, and to 5 per cent in 2015-16.

5.8 The thin capitalisation rules which deal with the allocation of debt capital for the Australian operations of inward investors in the non-finance sectors are:

- Safe harbour test – debt must not exceed 75 per cent of assets of the Australian branch operations.
- Arm's length debt test – the debt of the Australian branch operations must not exceed the lesser of the following:
 - the debt capital attributable to its Australian business that the entity would reasonably be expected to have if it had just carried on the Australian operations; or
 - the debt that independent commercial lending institutions would reasonably be expected to lend to the Australian business under terms and conditions that would reasonably be expected if the lenders and the entity were dealing at arm's length with each other.
- Australia's thin capitalisation regime does not require that minimum capital be held against foreign branch operations of Australian residents. This is an example of a difference between the authorised OECD approach and Australia's thin capitalisation regime, in that the authorised OECD approach does require that minimum capital to be held by the relevant PE. This does not, however, necessarily imply that adoption of the authorised OECD approach in Australia would require a change to Australia's thin capitalisation regime. At the same time, the implications of such a difference may need to be considered.

Q 5.1 Issues/Questions

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

Specific issues in this regard include:

- what are the implications for the domestic tax law and for tax treaty policy of Australia adopting the authorised OECD approach?
- should the authorised OECD approach be adopted on a treaty by treaty basis and, if that approach is adopted, the implications of having different rules in different treaties (and different respective commentaries to follow in applying those rules) or should Australia instead adopt the authorised OECD approach as part of Australia's domestic law for application in all circumstances, subject to conformity with any relevant treaty?
- what principles should be followed in amending the income tax legislation if the Government were to adopt the OECD functionally separate entity approach?
- whether there should be special rules in Australia for capital allocation to branch operations if Australia adopts the authorised OECD approach?
- what would be the impact on current tax practices of adopting the authorised OECD approach?

POTENTIAL RECONSIDERATION OF EXISTING TAX SETTINGS

5.9 As discussed in paragraph 3.8 of this Discussion Paper, double taxation on income from overseas branch operations of Australian enterprises is relieved in Australia through the exemption method or the credit method.

5.10 The 2010 OECD Model Commentary on Article 7 provides the following guidance regarding the relief of double taxation:

27. The opening words of paragraph 2 and the phrase 'in each Contracting State' indicate that paragraph 2 applies not only for the purposes of determining the profits that the Contracting State in which the permanent establishment is situated may tax in accordance with the last sentence of paragraph 1 but also for the application of Articles 23A and 23B by the other Contracting State. Where an enterprise of one State carries on business through a permanent establishment situated in the other State, the first-mentioned State must either exempt the profits that are attributable to the permanent establishment (Article 23A) or give a credit for the tax levied by the other State on these profits (Article 23B). Under both these Articles, that State must therefore determine the profits attributable to the permanent establishment in order to provide relief from double taxation and is required to follow the provisions of paragraph 2 for that purpose.

5.11 Because of the way in which Australia's network of double tax treaties operates with the Australian domestic law,³⁹ this part of the 2010 OECD Model Commentary does not necessarily lead to a conclusion that the combined tax effect of treatment applied in each jurisdiction will result in an entirely complementary calculation of the amount of income taxed in the foreign jurisdiction compared with the amount that might be exempt from taxation in Australia.

5.12 If the authorised OECD approach is adopted in Australia, a question arises whether changes to implement it should be restricted to the determination of the profits that are attributable to a PE for the purposes of Article 7 and Article 23 of a tax treaty. As noted above, the 2010 OECD Report and the 2010 OECD Model Commentary on Article 7 do not dictate the application of the authorised OECD approach except in relation to those relevant articles of the OECD model convention. However, this would not necessarily prohibit the introduction of specific rules that use the ideas underlying the authorised OECD approach to determine other issues of tax law. For example, qualifying internal dealings between the Australian resident and its foreign PE might be specifically recognised in the Australian domestic tax law for the following purposes:

- applying the Australian withholding tax rules to notional amounts of interest and royalties to the foreign PE;
- calculating non-assessable non-exempt foreign branch income of the foreign PE;
- calculating assessable foreign income derived through the foreign PE, for the purposes of determining the entity's entitlement to foreign income tax offsets in Australia; and
- determining whether other adjustments are to be made to the entity's assessable income or allowable deductions, to ensure that dealings between the Australian resident and its foreign PE are treated, to the extent possible, similarly to transactions between an Australian resident company and a foreign subsidiary.

It may be preferable, instead of making specific adjustments, to require the Australian resident entity to calculate the assessable income and allowable deductions of its Australian operations separately, and for that purpose to treat all recognised dealings between the Australian resident and its foreign PE, to the extent possible, similarly to transactions with a foreign associate.

5.13 In relation to the cases mentioned in the preceding paragraph a question arises as to whether the use of the ideas underlying the OECD approach should be adopted only

39 Australia's double tax treaties allow the country in which a PE is located to apply tax to business profits attributable to that PE and generally require Australia, subject to Australian law, to grant a credit for tax paid in the other country on income sourced in that country and taxable in Australia. But, in relation to the profits of a foreign PE, Australian domestic law generally applies the exemption model through section 23AH of the ITAA 1936. Australia's tax treaties do not deal with the operation of the Australian exemption method for PEs.

where a tax treaty applies, or where a tax treaty with new Article 7 applies, or in all cases.

5.14 A question also arises as to the approach to be adopted in the converse case where a foreign resident enterprise has a PE in Australia. In this situation, the OECD Commentary points out that treaties containing the new Article 7 would need to be modified in order to preserve Australia's right to treat intra-entity payments as income for any purposes other than the attribution of profits to PEs, for example, to levy interest withholding tax on a notional payment if the PE in Australia made a 'payment' of interest on a notional loan from the head office.

Q 5.2 Issues/Questions

The Board seeks stakeholder comments on:

- the effects that the adoption of the authorised OECD approach would have on:
 - Australian multinational enterprises carrying on business through offshore branches in key trading and investing destinations; and
 - foreign groups investing into Australia;
- whether there are any particular issues that arise for stakeholders in applying the authorised OECD approach to:
 - deemed PEs (for example, PEs that do not arise through having a fixed place of operation, but through deeming provisions, including but not limited to, use of substantial equipment, dependent agent arrangements and supervisory activities); and
 - PEs created for a specific, single project of limited duration such as a construction project.
- for treaty cases, whether there are any circumstances in which double taxation of income from overseas PEs of Australian enterprises could occur if Australia enters into a treaty adopting the authorised OECD approach. If so, what are those circumstances and what amendments to section 23AH of the ITAA 1936 or Division 770 of the ITAA 1997 would be necessary to ensure double taxation would be relieved or avoided;

Q 5.2 Issues/Questions (continued)

- in non-treaty cases, in the event that there is actual or potential double taxation, what amendments to section 23AH of the ITAA 1936 or Division 770 of the ITAA 1997 would be necessary to ensure double taxation would be relieved or avoided;
- in broad terms, the extent to which permanent establishments should be treated as subsidiaries for the purposes of the tax treatment of qualifying internal dealings. Particular questions in this regard are set out in the next two bullet points;
- if Australia adopts the authorised OECD approach in future tax treaties, should amendments be made to Australian domestic law to recognise 'notional' amounts charged on qualifying internal dealings (for example, notional rent, licensing payments, service payments, royalties, interest and foreign exchange gains and losses) for all Australian tax law purposes, for example:
 - calculating withholding tax payable by the foreign branch operations of an Australian resident on notional 'interest' or 'royalties' arising in accordance with the authorised OECD approach;
 - calculating the foreign branch income of Australian resident taxpayers under section 23AH and for the purposes of the foreign income tax offset rules; and
 - making whatever further specific adjustments are required to ensure that dealings between an Australian resident and its foreign PE are treated, to the extent possible, similarly to transactions between an Australian resident and a foreign subsidiary; or
 - as an alternative to the above, requiring an Australian resident entity to calculate the assessable income and allowable deductions arising from its Australian operations separately (instead of merely subtracting s 23AH branch profits from worldwide income), and for that purpose treating all recognised dealings between the Australian resident and its foreign PE, to the extent possible, similarly to transactions with a foreign associate.
- if Australia adopts the authorised OECD approach, should it make modifications to domestic law and the new Article 7 as necessary so that Australia would be able to apply the approach in the previous bullet point to an Australian PE of a foreign resident? This could include, for example:
 - calculating withholding tax payable by the Australian branch operations of a non-resident on notional 'interest' or 'royalties' arising in accordance with the authorised OECD approach.

CHAPTER 6: ADOPTING THE AUTHORISED OECD APPROACH — SPECIFIC KINDS OF OPERATIONS

BANKS AND GLOBAL TRADING BUSINESSES

6.1 The authorised OECD approach attributes profits to branch operations of banks and global trading businesses by reference to where the ‘key entrepreneurial risk-taking’ (KERT) functions take place. Non-KERT functions (for example, back-office support, payroll and operational risk management) are taken into account in attributing arm’s length profits to the branch operations but economic ownership of assets is not attributed to such functions (Part II, par 12 and 67).

6.2 Banking involves assuming risks in respect of transactions with customers. For example, when a loan is created, the bank may assume credit, interest rate and foreign currency risk. In retail banking, a significant part of the business is to sell loans to customers; client procurement is a key function, which entails the assumption of risks relating to these products (Part II, par 11). In wholesale banking the decision to lend and the determination of the terms of the loan to the customer is the most important function in creating the asset so all the risks initially lie where those decisions are made (Part II, par 9 and 11).

6.3 The 2010 OECD Report indicates the relevance of particular ‘KERT’ functions for attributing loans of a bank under functional analysis as follows:

Function (Part II, pgs. 65 — 66)	KERT function?	
	Retail banking	Wholesale banking
Loan creation		
Sales/Marketing: procuring clients	Yes: (Part II, par 11)	No
Sales/Trading: whether to lend, negotiation and pricing of the loan	No	Yes: (Part II, par 9)
Treasury: funding the loan	No	No
Sales/Support: finalising contract, checking security	No	No
Loan management		
Administering the loan, collecting payments	No	No
Monitoring risks: review ongoing creditworthiness, interest rate	No	No
Managing risks: whether risks should be hedged, pooled or set off, and active management of residual risk	No	Yes: (Part II, par 9)
Treasury: managing overall funding position and interest rate risk	No	No: (Part II, par 10)
Sales/trading: selling or securitising loan	No	No

6.4 The 2010 OECD Report indicates the relevance of particular ‘KERT’ functions for attributing financial contracts of a global trading business under functional analysis as follows:

Function (Part III, pgs. 116 to 121)	KERT function?
Sales and marketing Pure sales: General sales personnel (Part III, par 43)	No
Marketer: Dedicated sales staff. Manages the deal, obtain approvals, get final price from trader, finish the deal (Part III, par 46-48).	No
Dealing: Liaise with traders, negotiate terms with clients, structures product to suit client. This is where credit risk is taken on (Part III, par 45).	Yes for credit risk
<p>Trader and risk management: Initially takes on market risk and manages them (Part III, par 45). They do not deal with credit risk as this involves contact with specific clients (Part III, par 51).</p> <p>Initial risk assumption — Traders workout what risk firm is prepared to accept (and so what capital to commit) and how to manage it before setting the minimum price to charge (Part III, par 50; Part III, par 213).</p> <p>Note: This is not the ‘set the overall risk limit’ by management which is not a KERT function (Part III, par 76).</p> <p>Subsequent risk management — Decides whether to enhance or reduce total market exposure (Part III, par 55). Enhance by entering into transactions to increase risk; reduce by hedging some or all of the risk. The ‘net or portfolio’ hedge means it is difficult to identify particular transactions as hedges of other transactions (Part III, par 55).</p> <p>Difficult to separate risk initial assumption and its subsequent management as they are related (Part III, par 50).</p>	Yes for market risk (Part III, par 210)
Treasury: Ensures the firm has enough funds to meet its payment but at the same time, funds not sitting idly (Part III, par 60).	No
Back Office: Give advice on business, legal, accounting and tax (Part III, par 66).	No
Operational risk management. They are difficult to quantify and attribute so authorised OECD approach allows operational risks to be allocated proportionately (Part III, par 103).	No (Part III, par 84)

6.5 KERT functions affect how assets and risks are allocated. The assets follow functions principle means financial assets are allocated to where they are created and managed because this is the KERT function for these assets (par 16; Part III, par 220). Similarly, it is the performance of the KERT functions that results in taking on the greatest risks (risks follow functions rule) (Part II, par 17-22; Part III, par 220) and this in turn affects the amount of free capital required to support the risks (capital follows risk principle) (Part II, par 17; Part III, par 220). The relevant KERT functions may be performed in more than one location (Part II, par 75).

6.6 Risks are initially allocated to where the KERT function relating to the creation of financial assets is performed:

- For a global trading business, credit risk is treated the same way as for banks. For market risk, the decision to assume the risk (sometimes called dealing or market-making function) and the subsequent management of risk (hedging or risk management function) are the KERT functions. These functions may be carried out by the same person or by different people in different parts of the global trading business (Part III, par 49). The price quoted by the trader must take into account assumptions about the firm's ability to manage the resulting risk. It may therefore be difficult in practice to segregate the risk assumption from the risk management function (Part III, par 50). Market risk initially lies where the decision to assume the risk was made (Part III, par 267).

6.7 Risks can be transferred if the relevant risk management function is transferred. However, credit risk is not transferred unless there is a relevant change in the location of the persons actually managing the relevant credit risk for the particular credit asset (Part III, par 268). A book entry cannot transfer credit risks (Part III, par 269).

6.8 The key principles applicable to the recognition of relevant risk transfers are as follows:

- There must be a transfer of the relevant risk management functions, not merely of risk monitoring (Part II, par 176; Part III, par 263):
 - The location to which the functions are transferred must perform relevant management functions for the risk and must have the capacity to evaluate and make relevant decisions about those risks (Part III, par 268; Part II, par 179).
- Active risk management, not strategic risk management, is relevant:
 - A bank and a global trading business may have different levels of risk-management. It is the active risk management that matters. Strategic risk management does not lead to the assumption of risk (Part II, par 180; Part III, par 263);
- Capital follows risk:
 - Like all businesses, banks and global trading businesses must hold capital for the risks they assume irrespective of whether they are regulated or not. So capital follows risk, not vice versa (Part II, par 180; Part III, par 263). It is not possible to have one part assuming the risk and another part with capital guaranteeing the risk-taker (that is the same credit worthiness principle) (Part II, par 66; Part III, par 205).

6.9 Market risk may be separated from credit risk and transferred by — for example — the use of an internal mirror swap that satisfies the following conditions (Part III, par 264-266):

- The swap is accompanied by a real and identifiable event, that is, a genuine change in the part of the enterprise managing the market risk;
- The spread appropriately rewards the transferor for the sale/marketing functions it performed, for taking on the credit risk and for on-going credit risk monitoring and management (Part III, par 264);
- The risk recipient is exposed to losses from adverse market movements; and
- The risk transferor is exposed to losses from the realisation of credit risks that it has retained (for example, customer defaults).

Asset attribution and internal transfers

6.10 As referred to previously, the assets follow functions rule means financial assets are initially allocated to where they are created and relevantly managed because this is where the KERT functions for these assets were performed (Part II, par 16; Part III, par 220).

6.11 If the books and records show that a financial asset has been subsequently transferred, those books and records are relevant only if they reflect a ‘real and identifiable event’ affecting the branch operations and the enterprise’s other operations, such as a change in which operations actually perform relevant functions related to the management of the financial asset (Part II, par 185).

6.12 Generally, the transfer of a financial asset will be found under comparability analysis to amount to a deemed disposal, with tax consequences for the transferor, and acquisition at market value. The recipient will have attributed to it income and expenses associated with the economic ownership of the asset, as well as free capital to support the risks emanating from the asset (Part II, par 186).

Capital (and interest cost) attribution to branch operations

6.13 The general principles on allocating capital apply here — the branch operations must have enough free capital and debt to support the functions it performs, the assets it uses and the risks it assumes (Part II, par 84; Part III, par 233).

6.14 A two-stage approach can be used. In the first stage, the functions performed by the branch operations determine the risks (including off-balance sheet risks) it takes on (Part II, par 89; Part III, par 235). The Basel Accord approach may be used to measure risk (Part II, par 94; Part III, par 236) to the extent it complies with the arm’s length principle (Part II, par 96; Part III, par 236). Internal risk models, such as an ‘Internal Ratings Based Approach’ to determining risk-weighting of assets, can also be used to

the extent they comply with the arm's length principle, are approved by the regulators, are applied consistently and sufficient details about the manner of determining the 'internal rating' or risk-weighting are made available to tax authorities for audit purposes (Part II, par 95; Part III, par 237). The models must be capable of determining risk-weighting at the branch operations level to be useful (Part II, par 95; Part III, par 237). Internal models applied on a consolidated basis will not be useful for this purpose.

6.15 In the second stage, free capital is allocated to support the branch operations' risk. The capital allocation approach and the thin capitalisation approach described in Chapter 4 can be used (Part II, par 97). The quasi thin capitalisation/regulatory minimum can be a safe harbour — that is, the branch operation has minimum capital equal to that required by regulators of an independent banking enterprise conducting the same operation — but is not an authorised approach because it ignores the same creditworthiness principle (Part II, par 113). Taxpayers may be able to demonstrate that the branch operations should have less capital than the safe harbour amount under the arm's length principle (Part II, par 114).

6.16 Interest-bearing regulatory capital (for example, subordinated debt) can be allocated by either allocating it the same way as for free capital, or allocating free capital first and treating the residual regulatory capital as an internal loan in accordance with the rules for qualifying internal dealings (Part II, par 117).

6.17 If regulatory debt capital is allocated the same way as free capital, the 2010 OECD Report provides guidance on how this may be done (Part II, par 118):

Approach used for free capital	Apply to debt capital
Capital allocation approach	Use the bank's BIS ratio to allocate total Tier-1 and Tier-2 regulatory capital to the branch operations
Thin capitalisation approach	Branch operations have the same interest-bearing regulatory capital and free capital as an independent bank with the same creditworthiness as the enterprise as a whole and conducting the same operations as the branch.
Quasi thin capitalisation/ regulatory approach	Branch operations have the minimum regulatory (interest-bearing and free capital) required of an independent bank with the same creditworthiness as its enterprise and conducting the same operations.

6.18 Under this first approach interest costs can then be attributed using the 'tracing method' or the 'fungible method': refer to paragraph 4.20 of this Discussion Paper.

6.19 Under the second approach, if interest-bearing regulatory capital is treated as an internal loan in accordance with the rules for qualifying internal dealings, the interest rate for the 'internal loan' is determined as the 'blended' interest rate reflecting the actual mix of regulatory capital of the bank. This is because banks source their funding from different channels with different maturity and corresponding cost profiles (Part II, par 120). Accordingly, an 'internal rate' priced at the wholesale interbank rate

may not be appropriate because it does not reflect the actual mix and cost of the bank's funds, particularly the higher cost of subordinated debt (Part II, par 121).

6.20 Australia's thin capitalisation rules govern the amount of deductible interest-bearing debt that Australian branch operations of foreign enterprises can have. Below is a summary of the tests applicable to inward investors in the financial sector:

Non-ADI, financial entities	Authorised Deposit-taking Institutions
Safe harbour test: debt must not exceed the lesser of 95 per cent of assets (disregarding 'on-lent', 'zero capital' and other amounts) and an amount equal to the amount lent by the entity plus 75 per cent of all other assets.	Safe harbour test: Australian equity capital must exceed 4 per cent of risk-weighted assets as determined by home country banking regulator or APRA (adjusted for certain items)
<p>Arm's length debt test: the Australian debt must not exceed the lesser of the following:</p> <ul style="list-style-type: none"> • the debt capital attributable to its Australian business that the entity would reasonably be expected to have if it had just carried on the Australian operations; and • the debt that independent commercial lending institutions would reasonably be expected to lend to the Australian business under terms and conditions that would reasonably be expected if the lenders and the entity were dealing at arm's length with each other. 	Arm's length capital test — Australian equity must be no less than the equity that an independent entity carrying on the Australian branch operations would hold.

Q 6.1 Issues/Questions

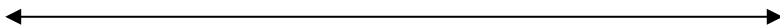
The Board seeks stakeholder comments on:

- whether compliance with the foreign bank's home regulator's rules with respect to capital allocation are relevant to establish compliance with the requirements of the authorised OECD approach by Australian branches of foreign banks?
- what are the implications of the constant changes to the operational environment and prudential regulatory environment for banks to the application of the authorised OECD approach?

Applying the authorised OECD approach to attribute external loans to Australian branch operations of banks

6.21 A key question is whether the foreign bank's funding of its Australian branch operations, apart from any funds raised locally by the branch, is provided as a conduit through the foreign bank's other operations, or whether the funding, aside from the amount that is to be treated as regulatory capital, deserves a full lending return.

‘Conduit’ refers to the situation where the branch operations use other operations of the bank as an instrument to raise its funds overseas (Part II, par 192).

Conduit	Not conduit
	
Service-fee and external interest cost allocated to PE	Lending return on notional loan, that is an interest rate reflecting the foreign enterprise’s actual mix and cost of funds

6.22 The foreign bank’s funding of its Australian branch operations is provided by the bank as a conduit if the branch operations (Part II, par 195, 196):

- made the decision to raise funds;
- made the decision to enter the market at a particular time;
- made the decision as to what terms should be sought etc; and
- effectively took on the risks of borrowing – for example, the funds were borrowed for the purpose of funding the branch operations or the branch operations are responsible for the profitable use of those funds.

6.23 If the foreign bank’s funding of its Australian branch operations is not provided by the bank as a conduit, the interest pricing on the qualifying internal ‘loan’ dealing must comply with the arm’s length principle. This means, there is a need to :

- determine the rate of interest that reflects the circumstances in which the funds have been provided (Part II, par 165);
- ensure that the ‘blended’ interest rate reflects the actual mix of funds of the bank (including subordinated debt) which may not be reflected in the wholesale rate (refer to paragraph 6.19 of this Discussion Paper); and
- ensure the rate reflects the absence of differential credit risk, since the Australian branch operations share its bank’s creditworthiness (Part II, par 167).

Applying the authorised OECD approach to attribute external lending to Australian branch operations of banks

6.24 If all the relevant decisions were made and functions leading to the creation of the external loans were performed in the course of the branch operations, there should be little difficulty in determining the amount of profit to be attributed to the branch operations in respect of the loans (Part II, par 157).

6.25 The authorised OECD approach is that a financial asset belongs (is owned) where the KERT functions for the financial asset took place. This is usually where the asset is created and relevantly managed. The location of the external lending depends on whether the branch operations are engaged in retail or commercial lending. Refer to paragraphs 6.3 to 6.12 of this Discussion Paper for the relevant 'KERTs functions' in attributing loan assets.

Applying the authorised OECD approach to internal derivatives and foreign currency gains and losses arising out of the internal dealings

6.26 The Board has been asked to examine whether granting Australian tax recognition for particular intra-entity dealings that meet the requirements of the new OECD Article 7 may pose risks and how those risks could be managed. Internal derivatives and foreign currency exchange rate gains and losses are two areas that the Board has been asked to examine in particular.

6.27 The conditions for recognising qualifying internal dealings are referred to in paragraphs 4.23 to 4.27 of this Discussion Paper.

6.28 The factual and functional analysis must reveal that a real and identifiable event has occurred that is economically significant enough to constitute a qualifying internal dealing (par 35 and par 175 to 182).

Q 6.2 Issues/Questions

The Board seeks stakeholder comments relating to internal derivatives and foreign currency gains and losses in respect of the recognition of qualifying internal dealings, particularly in terms of the requirements set out in the 2010 OECD Report for their tax recognition and having regard to the terms of reference.

Views are specifically sought on:

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

INSURANCE

6.29 Part IV of the 2010 OECD Report is concerned with the application of the authorised OECD approach to PEs of insurance enterprises. At present Australia excludes the taxation of insurance enterprises from the general principles of the business profits article in tax treaties and preserves the domestic law for taxing foreign insurers. These rules are found in Div 15 of Part III of the ITAA 1936. They deem the premium to be assessable income of the insurer sourced in Australia if:

- the insured property is in Australia;
- the insured event can only happen in Australia; or
- the insured person is a resident and an agent or representative of the insurer in Australia was in any way instrumental in inducing the insured to enter into the contract.

6.30 If the insurer has a principal office or branch in Australia then it files a tax return and is taxed under domestic law. Otherwise, the insurer is deemed to have taxable income equal to 10 per cent of the premiums unless the insurer can show its actual taxable income to the satisfaction of the ATO. Collection of tax is also facilitated by Division 15. The 2010 OECD Report is premised on the basis that the new Article 7 applies to insurance businesses. As this is not the case in Australia, there is a preliminary question whether Australia should change its tax treaty policy to bring insurers into the general operation of the business profits article.

6.31 The 2010 OECD Report recognises that an insurance business will have one KERT function, namely the assumption of insurance risk (Part IV, par 69). Various activities will contribute to that process, including setting the underwriting policy, risk classification and selection, pricing, risk retention analysis and acceptance of insured risk (Part IV, par 94) and their relative importance is likely to vary according to the particular facts and circumstances (Part IV, par 69).

6.32 The assumption of insurance risk by branch operations requires the attribution to those branch operations of the economic ownership of investment assets, along with the associated income and expense, sufficient to cover the surplus and reserves necessary to support that risk (Part IV, pars 103 and 104).

6.33 Where the various activities forming part of the KERT function leading to the assumption of insurance risk have been performed by more than one part of the insurance business, the relative value of those activities performed in different parts of the enterprise will be used to attribute the insurance risk and the associated underwriting and investment income from investment assets (Part IV, par 108).

Q 6.3 Issues/Questions

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

Specific questions in this regard are:

- Should Australia bring insurers within the general ambit of the business profits article in future treaties?
- If this happens, how should Australia deal with the following issues:
 - interpretation of the terms ‘surplus’ and ‘reserves’ in applying the authorised OECD approach to insurers;
 - identification of the indicators of insurance risk being assumed; and
 - identification of the circumstances in which other functions (for example, product development, sales and marketing, and risk management) will be relevant to the assumption of insurance risk?

Allocation of investment assets

6.34 The two methods in the authorised OECD approach for allocating total investment assets are (i) Capital Allocation Approach, and (ii) Thin Capitalisation/Adjusted Regulatory Minimum Approach.

6.35 Under the capital allocation approach, the principles are (Part IV, par 131):

- The investment assets of an insurance business are available to support all its business, irrespective of where the business is conducted.
- All of the investment assets of the entire business must be attributed to the various parts of the business and, accordingly, the sum of the attributed investment assets will be neither more nor less than the total investment assets belonging to the business as a whole.

6.36 The investment assets are allocated based on the portion of insurance risks assumed by each part of the insurance enterprise. This is based on facts and circumstances (Part IV, par 151), but potential drivers include:

Drivers	Practical problems
Reserves (liabilities) for insurance risk as per books	<ul style="list-style-type: none"> • Lack of international uniformity in insurance regulation. Some countries require more reserves (liabilities) and less surplus (equity), and vice versa. • Whether to use the regulations of home country or branch country.
Insurance premiums	<ul style="list-style-type: none"> • There may not be a direct relationship between premiums and assets required to support the risk.
Regulatory and hybrid approaches	<ul style="list-style-type: none"> • Regulatory measures such as solvency margins, minimum regulatory asset requirement may indicate where risks lie.

6.37 Part IV, par 141 of 2010 OECD Report states:

Where, however, the reserves and minimum surplus required by the regulator to be held as trustee assets in the branch jurisdiction exceed the investment assets that would be attributed to the branch under the capital allocation approach and *there is no conflict between the tax and regulatory attribution of risk to the branch*, an appropriate arm's length result would attribute those trustee assets to the branch, as they reflect the amount of assets the branch would hold if it were a separate and independent enterprise [emphasis added].

Q 6.4 Issues/Questions

The Board seeks stakeholder comments on the following issues if Australia were to apply the business profits article to insurers:

- Would there be circumstances where there would be a conflict between the tax and regulatory attribution of risk to the branch?
- What rules should apply if there would be a conflict between the tax and regulatory attribution of risk to the branch?

6.38 The thin capitalisation/adjusted regulatory minimum approach starts with the regulatory reserves and surplus of the insurance enterprise, and adjusts it to reflect the arm's length principle (Part IV, par 154). The books and records of the branch may assist in showing the nature of the activities carried on by the branch and the level of assets that the branch needs to perform those activities. But the books may need to be adjusted to ensure that the reserves and surplus attributable to the branch are similar to the levels held by insurance businesses engaged in similar activities and taking on similar level of insured risks operating in the host country (Part IV, par 155).

6.39 A pure regulatory reserves/surplus approach (that is, the 'safe harbour quasi thin capitalisation/regulatory minimum approach') is not an authorised OECD approach as it is not consistent with the same creditworthiness principle of the authorised OECD approach (Part IV, par 160). This safe harbour approach attributes investment assets to insurance branch operations based on what investment assets an independent insurance enterprise carrying on the same or similar activities and assuming similar risks would have under similar conditions (Part IV, par 153). It may, however, be acceptable as a domestic safe harbour provided it does not give rise to non-arm's length outcomes (Part IV, par 160).

Q 6.5 Issues/Questions

The Board seeks stakeholder comments on:

- whether there should be special rules in Australia for capital allocation to branch insurance operations if Australia adopts the authorised OECD approach?

Investment yield

6.40 The return earned on the investment assets that are properly attributable to the branch operations should in principle correspond closely to the return earned on investment assets actually held in the branch country to support the insurance contracts issued by the branch (Part IV, par 166).

6.41 Under a ‘top-down approach’, where the amount of investment assets attributed to the branch operations exceeds the amount of investment assets actually held in the branch country, those additional assets should earn a rate of return equal to the rate of return (taking into account those assets which do not give rise to income) earned on all investment assets held by the foreign enterprise that are not required to be held in trust accounts in other countries to support business written in those countries (uncommitted investment assets). Alternatively, one could try to identify the yield on those categories of the insurance company’s uncommitted investment assets that are most appropriate to associate with the branch operations, in light of the nature of the insurance risk assumed by the branch operations (Part IV, par 167 and 168).

6.42 Under a ‘bottom-up approach’, the rate of return earned on investment assets held in the branch country is assumed to also be earned by the uncommitted investment assets (Part IV, par 170).

Reinsurance

6.43 Australia also has special rules for reinsurance in Division 15 and preserves the operation of these rules in its treaties, that is, the general principles of the business profits article are not applicable. Hence the OECD discussion of reinsurance will only be relevant if Australia brings reinsurance within the general ambit of the business profits article in Australia’s bilateral tax treaties. Under the 2010 OECD Report for external reinsurance, the PE operations should bear the cost of the external reinsurance to the extent that the reinsurance provides a potential benefit to the PE operations by achieving a cession of insurance risk assumed by the PE operations (Part IV, par 171).

6.44 If it can be demonstrated that another part of the enterprise has performed the relevant KERT function, then the conditions may be met for recognising an internal reinsurance dealing (for example, the risk management function of deciding whether to reinsure cannot be done after insured risks have been assumed.) Otherwise the branch operations which accepted the insurance risk is compensated on a services basis (Part IV, par 179).

Q 6.6 Issues/Questions

The Board seeks stakeholder comments on the following questions:

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

CHAPTER 7: ADOPTING THE AUTHORISED OECD APPROACH — ADMINISTRATION, COMPLIANCE AND REVENUE IMPACTS

ADMINISTRATION AND COMPLIANCE IMPACTS

7.1 As noted at paragraph 4.8, the authorised OECD approach involves two steps.

7.2 Step 1 under the authorised OECD approach is similar to the functional analysis that currently applies to determine the profits attributable to branch operations. As per Step 1, the functional analysis looks at:

1. the economically significant activities or functions actually undertaken by the PE (including their nature and frequency) and the rest of the enterprise;
2. the risks each part of the enterprise thereby assumes; and
3. the assets (both tangible and intangible) used or to be used by each part of the enterprise and the nature and extent of that use or intended use.

7.3 However, Step 2 of the authorised OECD approach is new because it requires that all qualifying internal dealings be priced by analogy with the Transfer Pricing Guidelines, whereas the current Australian approach allocates external income and expense based on functional analysis.

7.4 An issue here is whether it is feasible or practicable to obtain arm's length prices for qualifying internal dealings. For example, financial transactions with unrelated third parties may involve implied or actual credit support, which may require adjustments to obtain a pricing that meets an applicable same creditworthiness rule for the internal dealing. This adjustment can be complex given the range of pricings possible under credit enhancement mechanisms.

Q 7.1 Issues/Questions

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

- Will it be possible to find – in a cost efficient and objective manner – a comparable uncontrolled price for qualifying internal dealings? If so, please provide details of how this can be done?

Q 7.1 Issues/Questions (continued)

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

Q 7.1 Issues/Questions (continued)

- What would be the effects of adopting the authorised OECD approach in terms of positioning Australia as a financial centre?
- Would adopting the authorised OECD approach bring greater certainty to taxpayers and reduce compliance costs compared to the current Australian approach?
- Would adopting the authorised OECD approach reduce administrative costs compared to the current Australian approach?
- The current systems, processes and pricing methodologies used to evidence and price cross-border internal dealings that (if they were with a third party would be a financial transaction) and the extent to which (if any) there may be a need to adjust the prices in order to appropriately comply with the authorised OECD approach (refer, in this regard, to paragraph 4.5 of this discussion paper).
- What are the compliance cost implications of adopting the authorised OECD approach with respect to:
 - the required documentation for taxpayers, having regard to the need noted in the 2010 OECD Report for greater scrutiny of internal dealings and the Commentary view that it is not intended to impose more burdensome documentation requirement on PEs compared to associated companies; and
 - the requisite systems and processes that taxpayer entities would need to have in place?

REVENUE IMPACTS

7.5 The Board has been asked to consider the short-term and long-term impacts on taxation revenues of possible options in the context of the Government's fiscal position and strategy.

7.6 This analysis is made more complex by factors in the external environment, including profitability pressures on financial institutions and the existence of large tax losses in certain jurisdictions that may encourage re-location of losses where profits arise within the global enterprise to maximise tax efficiency. The latter may be sought to be done by the way in which charges are internally allocated and priced.

7.7 Tax arbitrage may also be sought to be undertaken through structuring of commercially or economically similar transactions that attract inconsistent tax treatment. An example in this regard may relate to structuring as either derivative instruments or insurance policies to achieve a tax arbitrage outcome.

7.8 It may also be possible for entities to use the authorised OECD approach attribution methodologies to reduce their overall global tax expense by determining the location of certain functions or services in PEs or the home country of the entity by reference to the tax rates applicable in each place. This could potentially result in high-cost head-office services being provided from PEs with lower domestic rates of tax, rather than in the home country of the entity to achieve a particular global tax expense outcome.

Q 7.2 Issues/Questions

The Board seeks stakeholder comments on:

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

CHAPTER 8: PART IIIB, THE LIBOR CAP AND THE AUTHORISED OECD APPROACH

PURPOSE AND OPERATION OF THE LIBOR CAP

8.1 The operation of the 'deemed interest' provisions in Part IIIB of the ITAA 1936 is set out in paragraphs 3.12 to 3.14 of this Discussion Paper.

8.2 In relation to the introduction of those provisions, the 'Banking Policy Statement' dated 18 June 1993, by the then Treasurer, the Hon John Dawkins, MP, stated:

'An important element in the determination of a foreign bank branch's profit is the calculation of the interest expense of the branch. Ordinarily, where a foreign bank's head office provides funds for use by an Australian branch, the branch would be allowed an allocation of the bank's worldwide interest expense as a deduction against its assessable income in Australia. The banking industry representatives have argued that to use a statutory formula to calculate the deductible interest expense would not be feasible commercially and would be complex administratively.

However, the basis on which interest costs are allocated to an Australian branch of a foreign bank has to allow auditors to check the validity of the expense that is claimed as well as allow the branch to price its transactions. The Government has accepted that there cannot be a precise measure that will be applicable in all cases and has decided therefore that in respect of intra-bank funding it will:

accept the branch's books as a starting point for the calculation of a branch's interest deduction, subject to a ceiling deduction based on an interest rate equal to the mean of the London inter-bank bid and offer rates that are prevailing at the relevant time.

8.3 Paragraph 11.10 of the Explanatory Memorandum to Taxation Laws Amendment Bill (No. 3) 1994 states:

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

8.4 The 'deemed interest' provisions in Part IIB were enacted as a particular treatment for Australian branch operations of foreign banks (and since 2005, have been available for other qualifying foreign financial entities):⁴⁰

1. enabling notional interest up to LIBOR to be deducted by the foreign bank as a reasonable proxy for the cost of inter-bank borrowing by the foreign bank to provide debt funds to its Australian branch; and
2. with the right to elect out of the provisions, so that if the foreign bank's actual interest costs of funding its Australian branch operations are higher than the deemed 'notional interest' capped at LIBOR, the bank can instead deduct its higher actual cost.

8.5 The Johnson Report⁴¹ recommended that the LIBOR cap in Part IIB be removed (Recommendation 3.5). The Report states:

As the financial crisis clearly demonstrated, in periods of stress in credit markets there can be appreciable differences between the LIBOR rate and the rates that parent banks are able to offer their Australian branches on a commercial basis. While conditions in credit markets have eased significantly, Australia needs policies to ensure access to alternative funding sources at competitive rates should such tensions re-emerge. The Forum believes that any tax avoidance concerns resulting from removing the LIBOR cap could be adequately dealt with by applying the usual transfer pricing guidelines in respect of interest paid to foreign banks by their Australian branches. Transfer pricing rules aim to avoid the underpayment of tax by requiring businesses to price related party international dealings according to what independent parties would reasonably be expected to have done in the same situation (the 'arm's length principle').

8.6 Since the Johnson Report was finalised it has become apparent that for periods during the last decade LIBOR may have understated the average cost of bank-to-bank borrowing which it was meant to reflect. As the US and UK authorities continue to investigate it can be expected that LIBOR should accurately reflect the actual average cost of bank to bank borrowing in the future.

40 Section 160ZZZK of the ITAA 1936.

41 Report by the Australian Financial Centre Forum (2009), *Australia as a Financial Centre - Building on our Strengths*.

INCONSISTENCIES BETWEEN PART IIIB AND 2010 OECD APPROACH

8.7 As set out in paragraphs 4.15 to 4.22 and 6.13 to 6.20 of this Discussion Paper, the authorised OECD approach requires free capital and debt to be allocated to a branch:

- according to functions performed and risks thereby assumed; and
- having regard to the arm's length principle – that is, having regard to what capital an independent enterprise performing the functions of the branch, using the same assets and assuming the same risks would have after applying the same creditworthiness rule.

8.8 The deemed interest provisions in Part IIIB, while having some of the characteristics of the functionally separate entity approach, do not have any such requirements.

REVENUE IMPACT OF REMOVING LIBOR CAP ON INTERNALLY RECORDED 'INTEREST'

8.9 The Board has been asked to consider the short-term and long-term impacts on taxation revenues of possible options in the context of the Government's fiscal position and strategy.

Q 8.1 Issues/Questions

The Board seeks stakeholder comments on:

- Your views on whether Part IIIB is consistent with the KERT and other requirements of the authorised OECD Approach (as set out in Chapters 4, 5 and 6 of this Discussion Paper)?
- If Part IIIB is not consistent with the requirements of the authorised OECD Approach, how Part IIIB should be amended to facilitate the authorised OECD approach?
- If Part IIIB is retained with a cap on the interest rate that can be charged on notional debt, which international benchmark rate would be the most appropriate, and why?
- If Part IIIB is retained but the LIBOR cap is removed, what would be the expected impact on:
 - the level of Australian tax paid on the profits of Australian branch operations of foreign banks and other qualifying financial entities?
 - banking competition?

Q 8.1 Issues/Questions (continued)

- The methodology (including inputs from market sources) for determining the rates and prices internally charged by foreign banks to their Australian branches, including the circumstances and variables taken into account, for each of the following kinds of internal dealings recorded with respect to the entity's own branch operations and covered by Part IIIB:
 - internal funding or 'loans' (Australian dollar and foreign currency denominated);
 - internal derivatives (Australian dollar and foreign currency denominated);
 - spot foreign currency transactions; and
 - other kinds of internal dealings (such as capital assets).
- For the above, what would be the outcome if the functional currency is not the Australian dollar? For this situation, please provide examples for financial arrangements denominated in both the functional currency and other than in the functional currency.

GLOSSARY

ADI	Authorised Deposit-Taking Institution
APRA	Australian Prudential Regulation Authority
Article 7	Article 7 (Business Profits) and Commentary in the OECD Model Tax Convention on Income and on Capital
ATO	Australian Taxation Office
The Board	Board of Taxation
CGT	Capital gains tax
CCA	Cost-Contribution Arrangement
KERT	Key Entrepreneurial Risk-Rating
ITAA 1953	International Tax Agreements Act 1953
ITAA 1936	Income Tax Assessment Act 1936
ITAA 1997	Income Tax Assessment Act 1997
IWT	Interest Withholding Tax
Johnson Report	Report of the Australian Financial Centre Forum, Australia as a Financial Centre — Building on our Strengths
LIBOR	London interbank Offer Rate
OBU	Offshore Banking Unit
OB activities	Offshore Banking Activities
OECD	Organisation for Economic Co-operation and Development
Part IIIB	Part IIIB of the Income Tax Assessment Act 1936
PE	Permanent Establishment
SNF Case	Commissioner of Taxation v SNF (Australia) Pty Ltd [2011] FCAFC 74 91 June 2011)
2010 OECD Report	The 2010 OECD Report on the Attribution of Profits to Permanent Establishments

APPENDIX A: QUESTIONS

CHAPTER 2: OVERALL POLICY OBJECTIVES AND PRINCIPLES FOR ASSESSMENT OF THE FUNCTIONALLY SEPARATE ENTITY APPROACH

Q 2.1 Issues/Questions

The Board seeks stakeholder comments on:

- reasons for using a permanent establishment rather than a subsidiary;
- the type of activities undertaken by and channelled through permanent establishments (for example, wholesale banking and other financial services, construction services and other non-financial services, intra entity fee based services); and
- the size or extent of use of the permanent establishments relative to any subsidiaries that particular businesses use.

CHAPTER 4: THE AUTHORISED OECD APPROACH

Q 4.1 Issues/Questions

The Board seeks stakeholder comments on:

- whether there are other countries which are likely to adopt the new Article 7 in their bilateral tax treaties;
- whether there are reasons other than those given by the United Nations Committee of Experts (see paragraph 4.32) for certain countries not adopting the new Article 7 in their bilateral tax treaties; and
- whether there are any examples of inconsistent application between domestic tax law and tax treaty policy in countries adopting the new Article 7.

CHAPTER 5: ADOPTING THE AUTHORISED OECD APPROACH IN AUSTRALIA

Q 5.1 Issues/Questions

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

Specific issues in this regard include:

- what are the implications for the domestic tax law and for tax treaty policy of Australia adopting the authorised OECD approach?

- should the authorised OECD approach be adopted on a treaty by treaty basis and, if that approach is adopted, the implications of having different rules in different treaties (and different respective commentaries to follow in applying those rules) or should Australia instead adopt the authorised OECD approach as part of Australia's domestic law for application in all circumstances, subject to conformity with any relevant treaty?
- what principles should be followed in amending the income tax legislation if the Government were to adopt the OECD functionally separate entity approach?
- whether there should be special rules in Australia for capital allocation to branch operations if Australia adopts the authorised OECD approach?
- what would be the impact on current tax practices of adopting the authorised OECD approach?

Q 5.2 Issues/Questions

The Board seeks stakeholder comments on:

- the effects that the adoption of the authorised OECD approach would have on:
 - Australian multinational enterprises carrying on business through offshore branches in key trading and investing destinations; and
 - foreign groups investing into Australia;
- whether there are any particular issues that arise for stakeholders in applying the authorised OECD approach to:
 - deemed PEs (for example, PEs that do not arise through having a fixed place of operation, but through deeming provisions, including but not limited to, use of substantial equipment, dependent agent arrangements and supervisory activities); and
 - PEs created for a specific, single project of limited duration such as a construction project.
- for treaty cases, whether there are any circumstances in which double taxation of income from overseas PEs of Australian enterprises could occur if Australia enters into a treaty adopting the authorised OECD approach. If so, what are those circumstances and what amendments to section 23AH of the ITAA 1936 or Division 770 of the ITAA 1997 would be necessary to ensure double taxation would be relieved or avoided;
- in non-treaty cases, in the event that there is actual or potential double taxation, what amendments to section 23AH of the ITAA 1936 or Division 770 of the ITAA 1997 would be necessary to ensure double taxation would be relieved or avoided;
- in broad terms, the extent to which permanent establishments should be treated as subsidiaries for the purposes of the tax treatment of qualifying internal dealings. Particular questions in this regard are set out in the next two bullet points;

- if Australia adopts the authorised OECD approach in future tax treaties, should amendments be made to Australian domestic law to recognise ‘notional’ amounts charged on qualifying internal dealings (for example, notional rent, licensing payments, service payments, royalties, interest and foreign exchange gains and losses) for all Australian tax law purposes, for example:
 - calculating withholding tax payable by the foreign branch operations of an Australian resident on notional ‘interest’ or ‘royalties’ arising in accordance with the authorised OECD approach;
 - calculating the foreign branch income of Australian resident taxpayers under section 23AH and for the purposes of the foreign income tax offset rules; and
 - making whatever further specific adjustments are required to ensure that dealings between an Australian resident and its foreign PE are treated, to the extent possible, similarly to transactions between an Australian resident and a foreign subsidiary; or
 - as an alternative to the above, requiring an Australian resident entity to calculate the assessable income and allowable deductions arising from its Australian operations separately (instead of merely subtracting s 23AH branch profits from worldwide income), and for that purpose treating all recognised dealings between the Australian resident and its foreign PE, to the extent possible, similarly to transactions with a foreign associate.
- if Australia adopts the authorised OECD approach, should it make modifications to domestic law and the new Article 7 as necessary so that Australia would be able to apply the approach in the previous bullet point to an Australian PE of a foreign resident?. This could include, for example:
 - calculating withholding tax payable by the Australian branch operations of a non-resident on notional ‘interest’ or ‘royalties’ arising in accordance with the authorised OECD approach.

CHAPTER 6: ADOPTING THE AUTHORISED OECD APPROACH — SPECIFIC KINDS OF OPERATIONS

Q 6.1 Issues/Questions

The Board seeks stakeholder comments on:

- whether compliance with the foreign bank’s home regulator’s rules with respect to capital allocation are relevant to establish compliance with the requirements of the authorised OECD approach by Australian branches of foreign banks?
- what are the implications of the constant changes to the operational environment and prudential regulatory environment for banks to the application of the authorised OECD approach?

Q 6.2 Issues/Questions

The Board seeks stakeholder comments relating to internal derivatives and foreign currency gains and losses in respect of the recognition of qualifying internal dealings, particularly in terms of the requirements set out in the 2010 OECD Report for their tax recognition and having regard to the terms of reference.

Views are specifically sought on:

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

Q 6.3 Issues/Questions

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

Specific questions in this regard are:

- Should Australia bring insurers within the general ambit of the business profits article in future treaties?
- If this happens, how should Australia deal with the following issues:
 - interpretation of the terms ‘surplus’ and ‘reserves’ in applying the authorised OECD approach to insurers;
 - identification of the indicators of insurance risk being assumed; and
 - identification of the circumstances in which other functions (for example, product development, sales and marketing, and risk management) will be relevant to the assumption of insurance risk?

Q 6.4 Issues/Questions

The Board seeks stakeholder comments on the following issues if Australia were to apply the business profits article to insurers:

- Would there be circumstances where there would be a conflict between the tax and regulatory attribution of risk to the branch?

- What rules should apply if there would be a conflict between the tax and regulatory attribution of risk to the branch?

Q 6.5 Issues/Questions

The Board seeks stakeholder comments on:

- whether there should be special rules in Australia for capital allocation to branch insurance operations if Australia adopts the authorised OECD approach?

Q 6.6 Issues/Questions

The Board seeks stakeholder comments on the following questions:

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

CHAPTER 7: ADOPTING THE AUTHORISED OECD APPROACH — ADMINISTRATION, COMPLIANCE AND REVENUE IMPACTS

Q 7.1 Issues/Questions

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

- Will it be possible to find – in a cost efficient and objective manner – a comparable uncontrolled price for qualifying internal dealings? If so, please provide details of how this can be done?
- How would entities substantiate:
 - the split of functions, risks and use of assets between head office and PEs consistent with the authorised OECD approach;
 - that, consistent with the authorised OECD approach, a qualifying internal dealing (including services) has occurred between a PE and head office; and
 - an appropriate pricing methodology for that qualifying internal dealing?
- What documentation and third party records are available to the ATO in Australia to review and establish arm's length pricing for the different types of cross border qualifying internal dealings?
- How do commercial practices such as credit enhancement and collateralisation (for example, centralised Credit Support Agreements netting multiple exposures under

derivatives across all operations including branch operations) affect the ability to determine an accurate arm's length price?

- Worked examples of how a range of commonly recorded internal dealings in financial arrangements (such as Australian dollar and foreign currency denominated internal loans and internal derivatives (swaps, forwards and options) as well as spot foreign currency transactions) would be treated for tax purposes under the functionally separate entity approach, as compared with the current Australian approach.
- The methodology (including inputs from market sources) for determining the rates and prices internally charged, including the circumstances and variables taken into account, for each of the following kinds of internal dealings recorded with respect to the entity's own branch operations:
 - internal funding or 'loans' (Australian dollar and foreign currency denominated);
 - internal derivatives (Australian dollar and foreign currency denominated);
 - spot foreign currency transactions; and
 - other kinds of internal dealings (for example, in relation to trading stock and capital assets).
- For the above, what would be the outcome if the functional currency is not the Australian dollar? For this situation, please provide examples for financial arrangements denominated in both the functional currency and other than in the functional currency;
- What would be the effects of adopting the authorised OECD approach in terms of positioning Australia as a financial centre?
- Would adopting the authorised OECD approach bring greater certainty to taxpayers and reduce compliance costs compared to the current Australian approach?
- Would adopting the authorised OECD approach reduce administrative costs compared to the current Australian approach?
- The current systems, processes and pricing methodologies used to evidence and price cross border internal dealings that (if they were with a third party would be a financial transaction) and the extent to which (if any) there may be a need to adjust the prices in order to appropriately comply with the authorised OECD approach (refer, in this regard, to paragraph 4.5 of this discussion paper).
- What are the compliance cost implications of adopting the authorised OECD approach with respect to:
 - the required documentation for taxpayers, having regard to the need noted in the 2010 OECD Report for greater scrutiny of internal dealings and the Commentary view that it is not intended to impose more burdensome documentation requirement on PEs compared to associated companies; and

- the requisite systems and processes that taxpayer entities would need to have in place?

Q 7.2 Issues/Questions

The Board seeks stakeholder comments on:

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

CHAPTER 8: PART IIIB, THE LIBOR CAP AND THE AUTHORISED OECD APPROACH

Q 8.1 Issues/Questions

The Board seeks stakeholder comments on:

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

- internal derivatives (Australian dollar and foreign currency denominated);
 - spot foreign currency transactions; and
 - other kinds of internal dealings (such as capital assets).
- For the above, what would be the outcome if the functional currency is not the Australian dollar? For this situation, please provide examples for financial arrangements denominated in both the functional currency and other than in the functional currency.

APPENDIX B: ARTICLE 7 (BUSINESS PROFITS) OF THE OECD MODEL TAX CONVENTION ON INCOME AND ON CAPITAL

New Article 7	Old Article 7
<p>1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.</p> <p>2. For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.</p> <p>3. Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.</p>	<p>1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.</p> <p>2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.</p> <p>3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.</p> <p>4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of</p>

New Article 7	Old Article 7
<p>4. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.</p>	<p>apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.</p> <p>5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.</p> <p>6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.</p> <p>7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.</p>