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The Secretary
House Standing Committee on Economics
House of Representatives
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Parliament House
CANBERRA ACT 2600

Email: economics.reps@aph.gov.au

Dear Sir/Madam,

Submission regarding *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*

We welcome the opportunity to comment on the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 ("**the Bill**") and the accompanying explanatory memorandum.

Our comments are limited to the Bill's proposed insertion of Subdivision 815-C into the Income Tax Assessment Act 1997 ("**ITAA 1997**"). Proposed Subdivision 815-C concerns the allocation of profits to permanent establishments, and will affect the calculation of foreign branch profits of Australian resident banks.

We note that the Board of Taxation is currently reviewing tax arrangements applying to permanent establishments and is due to report to the Government by 30 April 2013 on the impacts of Australia adopting the authorised OECD approach ("**AOA**") to the attribution of profits to permanent establishments. Even if the Government decides to implement the AOA, doing so might take a number of years because of the need to renegotiate tax treaties with all of Australia's existing tax treaty partners. Our focus in this letter is not on the merits of adopting the AOA but on making the proposed amendments in Subdivision 815-C, including their interaction with the existing law, workable in the context of the international banking operations conducted by our members.

Our three submissions are stated in ***bold italics*** below.

1. Background

A major issue in the allocation of profits to permanent establishments is the treatment of internal dealings between a permanent establishment and the rest of the entity of which it is part.

Such dealings are an integral and essential part of the business of international banking. For example, funds that form part of a pool of funds raised by an Australian-based treasury operation of an Australian bank may be used in a business conducted through the bank's branch in London. The provision of the

funds by the Australian treasury operation to the London branch may be regarded as an internal dealing. Similarly, an Australian resident bank may originate an interest rate risk as a result of a transaction entered into through its Singapore branch and may transfer responsibility for managing that risk, through an internal dealing, to its Melbourne office, which then manages the risk by entering into appropriate risk management transactions in the financial markets.

The treatment of internal dealings, in the context of international banking operations, is uncertain under the current Australian income tax law. It is clear that the financial results of internal dealings, as recorded in branch accounts, are not themselves income or expenditure under current Australian income tax law; but it is also clear that economically significant activities conducted at or through a permanent establishment are to be taken into account in allocating part of the "real" (that is, externally derived or incurred) income and expenditure (including losses) of the entity as a whole to the permanent establishment.

The branch accounting systems implemented by our members are designed to reflect the financial results of economically significant activities undertaken by their foreign branches, including the results of economically significant intra-entity dealings, and are therefore relied upon by our members to allocate amounts of "real" income and expenditure of the bank (that is, income derived from transactions with other parties and expenditure, including losses, incurred in transactions with other parties) to their foreign branches, even though it is impossible to identify which specific items of "real" income and expenditure have been allocated, through this process, to foreign branches as a result of the intra-entity dealings...

The treatment adopted by our members is supported by Taxation Ruling TR 2005/11 in relation to intra-entity funding arrangements but there is no formal guidance on the treatment of intra-entity banking dealings that do not take the form of funding.

2. Proposed Subdivision 815-C contains rules that should apply generally, not selectively

Against that background, our members would support a measure that:

a) clarifies the principles to be used to allocate profits to permanent establishments; and

b) incorporates an arm's length test for the purpose of ensuring that profits are allocated to permanent establishments in accordance with the appropriately valued economically significant activities of permanent establishments.

Unfortunately, proposed Subdivision 815-C as currently drafted does not achieve that result. A major reason for that failure is that proposed Subdivision 815-C would operate in one direction only: to increase taxable income, reduce losses and reduce tax offsets.

A question of allocating profits to a permanent establishment of an entity, with which proposed Subdivision 815-C is concerned, is conceptually different to a question of determining the appropriate commercial terms of arrangements between associated entities, with which proposed Subdivision 815-B is concerned.

In the latter case, the associated entities have the legal capacity to determine the terms of legally binding arrangements between them, and if those terms are not arm's length terms, then it is appropriate that the Australian income tax law should impose arm's length terms on those arrangements.

In the former case, however, the permanent establishment and the rest of the entity of which the permanent establishment is part are not separate legal persons and so cannot enter into legally binding arrangements in relation to the allocation of profits. The appropriate allocation of profits to permanent

establishments, for Australian income tax purposes, is a matter of Australian income tax law, and it is important that a single, comprehensive set of rules and guidelines should apply to the allocation of profits to permanent establishments for all purposes of Australian income tax law. Proposed Subdivision 815-C would not achieve that. It would leave untouched the present very unclear operation of the general income tax law and it would establish a parallel regime that would apply only if the existing, unclear regime produces a result that is less favourable to the taxpayer than proposed Subdivision 815-C.

Our members consider that it is not appropriate to introduce comprehensive rules for the allocation of profits to permanent establishments that operate in one direction only, against the taxpayer, instead of operating as a single, comprehensive set of rules for the allocation of profits to permanent establishments for all relevant purposes of the Australian income tax law.

We submit, therefore, that the operation of proposed Subdivision 815-C should be expanded so that the principles of allocation that it sets out apply for all purposes of the Australian income tax law and not merely as an anti-avoidance measure.

Suggested amendments to give effect to this change are described in section 1 of the Annexure to this letter.

3. Banks should not be required to identify which specific items of income and expenditure have been attributed to their permanent establishments

Even if proposed Subdivision 815-C operates as a general set of rules for allocating profits to permanent establishments, and not merely in one direction as an anti-avoidance measure, it will not entirely resolve the uncertainties mentioned in section 1 above because it will continue to be impossible to identify which specific items of income or expenditure, including losses, have been allocated to a permanent establishment, using the "arm's length profits" rules set out in the proposed measure.

It is unsatisfactory for the law to require taxpayers to apply the "arm's length profits" rules to allocate specific items of income and expenditure to permanent establishments in the context of international banking operations if it is impossible to do so. It should be sufficient for taxpayers conducting international banking operations to show that the profits allocated to their permanent establishments are appropriate, taking account of the hypotheses set out in paragraphs (a), (b) and (c) of subsection 815-225(1), the conditions specified in subsection 815-225(2) and the guidance set out in section 815-235.

We submit, therefore, that the proposed law should make it clear that it is not necessary for an authorised deposit-taking institution ("ADI")[1] to identify which specific items of income or expenditure arising in the course of an international banking business are attributed to a permanent establishment in determining the arm's length profits of the permanent establishment, if it is not possible or practical to do so.

Suggested amendments to give effect to this change are contained in section 2 of the Annexure to this letter.

4. Proposed Subdivision 815-C should contain a deemed foreign source income rule

The taxation treatment of the foreign branch profits of an Australian resident company is governed by

[1] The position of tax consolidated groups including an ADI and a non-operating holding company needs to be considered

(a) the general assessment and deduction rules in the income tax law, as modified by a specific provision, section 23AH of the Income Tax Assessment Act 1936 ("**ITAA 1936**"), dealing with "foreign branch income"; and

(b) the "taxation of financial arrangements" rules in Division 230 of Income Tax Assessment Act 1997 which, in the context of foreign branch operations, classify gains from financial arrangements by reference to whether the gains would be covered by section 23AH if the TOFA rules did not apply.

It is readily apparent that section 23AH is critical to the tax treatment of foreign branch profits of an Australian resident company. That section applies to income derived by an Australian resident company in carrying on business at or through a foreign permanent establishment, whereas the effect of proposed Subdivision 815-C is to change the amount of "profits" (not income) attributed to a permanent establishment.

Furthermore, section 23AH applies only to foreign income – that is, income which the Australian income tax law treats as having a foreign source. The Australian income tax principles that apply in determining whether income has a foreign source, and is therefore "foreign income", are not the same as the rules in proposed Subdivision 815-C for allocating income to permanent establishments. The existing rules in Division 13 of Part III of ITAA 1936 regarding the attribution of income and expenditure to permanent establishments, which will be repealed by the Bill, deal specifically with the source of income attributed to a permanent establishment. Proposed section 815-230 provides a deemed source for "the arm's length profits" of a permanent establishment in Australia or in an area covered by an international tax sharing treaty (such as the Timor Gap) but does not otherwise deal with the question of source in relation to amounts taken into account in determining the arm's length profits of a permanent establishment outside Australia.

We submit, therefore, that Subdivision 815-C should contain a clear rule that positive amounts taken into account in determining the arm's length profits of a permanent establishment outside Australia, other than amounts that are capital in nature, should be taken to be foreign source income.

Suggested amendments to give effect to this change are contained in section 3 of the Annexure to this letter.

We would be pleased to discuss these issues further.

Yours sincerely

Tony Burke

ANNEXURE: PROPOSED AMENDMENTS

1. Broadening the scope of proposed Subdivision 815-C

Proposed section 815-205: Object

Delete the words "not less than" and insert "the amount that it would be"

Proposed section 815-215: Substitution of arm's length profits

Substitute "transfer pricing effect" for "transfer pricing benefit" wherever those words appear.

Proposed section 815-220: When an entity gets a transfer pricing benefit

Substitute "transfer pricing effect" for "transfer pricing benefit" in the heading.

Replace subsection (1) with:

(1) An entity gets a transfer pricing effect from the attribution of profits to a *PE of the entity if the amount of profits (the actual profits) attributed to the PE differs from the *arm's length profits for the PE.

2. Clarifying that in the context of an international banking operation it is not necessary to identify specific items of income and expenditure allocated to a permanent establishment

Proposed section 815-225: Meaning of arm's length profits

Delete "and" at the end of paragraph (a) of subsection (3)

Delete the fullstop and add "; and" at the end of paragraph (b) of subsection (3).

Add the following paragraph after paragraph (b) of subsection (3):

(c) if it is not possible or practical for an *ADI to identify the specific items of income or expenditure arising from international banking transactions that have been allocated to the PE in calculating the arm's length profits of the PE, then it is not necessary to do so.

3. Deemed source of income rule

Proposed section 815-230: Source rules for certain arm's length profits

Change the heading to: **Deemed Australian and foreign source income rules**

Replace the existing subsections with:

For the purposes of *this Act, a positive amount that is taken into account in determining the *arm's length profits for a PE, other than an amount that is capital in nature, is taken to be income attributable to:

a) sources in Australia if the PE is in Australia;

b) foreign sources if the PE is outside Australia; and

c) sources in an *area covered by an international tax sharing treaty if the PE is in that area.