AUSTRALIAN BANKERS' ASSOCIATION INC.

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Mr Neil Motteram
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The Treasury
Langton Crescent
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Dear Neil,

Review of Australia's transfer pricing rules

We refer to the Consultation Paper ('the Paper') issued by Treasury entitled '*Income tax: cross border profit allocation, Review of transfer pricing rules*' (1 November 2011), and Media Release No 145 issued by the Assistant Treasurer Bill Shorten accompanying the Paper.

The Australian Bankers Association Inc (the 'ABA') welcomes and supports the review and updating of Australia's tax laws that deal with transfer pricing. Such a review and rewrite needs to be done in a comprehensive manner in order to meet the stated policy objectives, including the provision of enhanced tax certainty to businesses and investors.

In this submission, the ABA provides comments on the review and potential prospective rewrite of Australia's transfer pricing provisions which are contained in Division 13 of the Income Tax Assessment Act 1936 ('Division 13') and the retrospective legislative changes which were announced by the Assistant Treasurer in the Media Release.

The ABA's comments are expressed at a high level given the request by Treasury to comment on the broad principles and in light of a very short consultation period.

We understand the policy objectives of the review and potential re-write of Australia's transfer pricing rules to be:

(1) Ensuring that cross border profits attributed to the tax base appropriately reflect the economic activity undertaken in Australia (paragraph 25 of the Paper); and

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(Incorporated in New South Wales). Liability of members is limited.

(2) Aligning Australia's transfer pricing rules with the international transfer pricing standards, especially of major investment partners, and as outlined in the Model Tax Convention of the Organisation for Economic Co-operation and Development (the 'OECD') and the 2010 OECD Guidelines, which "*could reduce uncertainty, minimise compliance and administrative costs and reduce the risk of double taxation – thereby facilitating foreign direct investment*" (paragraph 26 of the Paper).

Comments of the ABA outlined below may make reference to these policy objectives throughout, referred to as Policy Objective 1 and Policy Objective 2, respectively.

Overall, the ABA welcomes any changes to the Australian domestic tax law that brings Australia's tax law in line with international consensus. The changes should be clear and unambiguous, apply equitably to all transfer pricing arrangements and align Australia with the international standards. Any changes that create new tax principles, sources of law or alternative potential taxing provisions will not achieve or align with these objectives.

For the ABA, the two significant aspects of the proposed changes that need to be seriously examined given their possible negative impacts on these stated policy objectives are:

(1) potential retrospective aspects of the proposed rules given widespread interpretation by tax advisors and taxpayers (both domestically and internationally) that treaties do not give or imply an alternative right (or mechanism) to taxation; and

(2) exclusion from the review of the attribution rules, which provide a universal set of common, clear and consistent rules for all entities and branches alike.

Retrospective legislation

The Media Release announcing the reform of the transfer pricing rules made it clear that Australian law would be amended to "clarify" that double taxation agreements ('treaties') operate as a separate taxing power (alternatively to the domestic tax law) and that the amendments would be made retrospectively effective 1 July 2004.

It is not entirely certain that Australia's treaties provide a separate taxing right as the issue has not to date been tested in the courts of law. It has not ever been interpreted or applied by taxpayers and advisors in this manner and on that basis, such a change would therefore be seen by most taxpayers as a retrospective change in law.

The proposed clarification, which will in effect have a retrospective impact on taxpayers, is a concern to the ABA as it will provide the Commissioner with an alternative taxing power through Australia's treaties. This is likely to provide the Commissioner with much broader powers to make a transfer pricing adjustment

than the domestic transfer pricing provisions contained within Division 13 and create a power for the Commissioner to choose alternative pricing mechanisms (leaving less certainty for taxpayers). This approach is not in accordance with international taxation norms.

Legislative amendments to taxation law are usually applied prospectively and only in rare cases will a change in policy intent be expressed to be applied retrospectively. The rationale for applying tax law prospectively, and not retrospectively, is centred around the recognition of the fundamental principles of tax policy (that is, equity, efficiency and simplicity), and the potential impact that retrospective legislation can have on certainty, transparency, neutrality, stability and integrity. We submit that retrospectivity is only potentially justifiable in extreme cases of extreme tax avoidance, such as the infamous bottom of the harbour schemes of the 1970s. To the best of our knowledge, there is no suggestion of significant tax avoidance with respect to Australia's domestic transfer pricing rules that would warrant a blanket retrospective change for all taxpayers.

A retrospective legislative change introduces uncertainty for Australian taxpayers as they have undertaken transfer pricing analyses and lodged income tax returns since July 2004 on the basis of Division 13 pursuant to Australia's self-assessment provisions. Whilst there are mechanisms in income tax law and Australia's treaties to deal with double taxation arising from a transfer pricing adjustment made by the Commissioner as a result the retrospective change, (Mutual Agreement Procedures or 'MAP'), these procedures are only effective to the extent that Competent Authorities are able to reach an agreement. As MAP provisions do not compel agreement between Competent Authorities, double taxation may still arise where there is no agreement as to the correct allocation of profits. Agreement is likely to be difficult to achieve on more complex matters (such as business restructuring where international consensus is still evolving) which increases the risk of double taxation for taxpayers.

At a practical level, the MAP process, triggered as a result of a potential double taxation, is not the preferred option as it will take time and be quite costly for taxpayers with no ultimate guarantee of a resolution. A MAP should be seen and remain a safety mechanism of last resort and it would not make sense to implement any tax law changes that may ultimately lead to greater tax uncertainty and the use of a MAP.

Further, the retrospective change applies only to taxpayers with dealings with related parties resident in countries with whom Australia has negotiated a treaty. Dealings with non-treaty countries would continue to be governed by domestic transfer pricing law. The ABA notes that applying different sets of rules to dealings with taxpayers in treaty countries (on the one hand) and non-treaty countries (on the other hand) is potentially prejudicial to treaty partner countries compared with non-treaty partner countries. It would be an anomalous result should the proposed changes have the effect of favouring trade with countries with whom Australia has *not* negotiated bilateral agreements. It is also at odds with the principle of equity for Australian taxpayers.

Finally, the ABA submits that the assertion that there is a prior and clearly articulated parliamentary intention that Australia's treaties are a separate taxing power is unfounded. The Assistant Treasurer's Media Release states that "*Parliament has indicated the law should operate in this way on a number of occasions, most recently in 2003*". In our view, this is far from clear in the 2003 Explanatory Memorandum ('EM') implementing the UK treaty and the oblique reference should not be interpreted in this way.

The ABA opposes the application of tax law change in a retrospective manner. Not only does this introduce uncertainty in the application of Australia's transfer pricing law, it has the potential to shape negative opinion about Australia and inhibit Australia's attractiveness as a destination for business activity and investment. This is at odds with Policy Objective 2.

We therefore submit that any legislative clarification should be prospective and should be incorporated into the proposed Division 13 rewrite.

Permanent establishments – attribution issues

According to paragraph 59 of the Paper, decisions relating to the treatment of permanent establishment ('PE') profit attribution rules ('PE attribution') will be treated by Treasury as a separate policy question and not addressed in any rewrite of Australia's transfer pricing rules.

The ABA is disappointed that an issue that has previously been subject to review recommendations[1], much lengthy discussion and debate between the ATO and industry members over the years, and which has given rise to considerable uncertainty about how Section 136AE, and Division 13 generally, should be applied to modern banking organisations, is not being included as part of an effort to update and modernise Australia's transfer pricing law.

If the transfer pricing aspects of PEs are not dealt with as a part of this review, international banking organisations (as well as participants in other industries who regularly use PE structures) will be faced with the prospect of applying the international consensus approach to associated enterprises, but an out-dated (non OECD compliant) approach to PE activities. This might lead to distorted outcomes and unequitable treatment for branches and separate legal entities.

More particularly for Australian banks, retaining the current "relevant business activity" approach will perpetuate the uncertainty which currently exists in relation to certain inter-entity transactions (for example internal derivative transactions) and potentially lead to disputes with offshore tax revenue authorities as to how inter-entity dealings are to be addressed. Most offshore tax revenue authorities are likely to endorse the authorised OECD separate entity approach. If differences arise as a result of the approach of the ATO vis-à-vis offshore authorities and double taxation arises as a result, taxpayers will only have recourse through the MAP, which as noted above does not guarantee an

outcome for taxpayers. Moreover, by applying a different approach to this issue than the broader international community, the advantages offered by Advance Pricing Arrangements, which are negotiated with two revenue authorities, will not be readily available to Australian banks which operate through a branch structure.

Further, a separate treatment for PEs may give rise to practical difficulties as bank systems and processes do not typically differentiate between different types of entities. This is at odds with Australia's stated policy objective of becoming a leading financial services centre in the Asia Pacific region.

It also means the current disparate legislative treatment[2] for the recognition of internal derivative and foreign exchange transactions between Australian banks and Australian branches of foreign banks and Offshore Banking Units[3] will remain, again giving rise to an inequitable and inconsistent treatment for Australian banks.

The ABA submits that Australia should make legislative and treaty amendments to move to a functionally separate entity approach for attributing profit within a single legal entity as prescribed by the OECD and that this legislative change be incorporated into the current review and potential rewrite of Australia's transfer pricing rules.

The Treasury has invited comments regarding the potential revenue impact of a change in approach to PEs. The ABA members are not aware of any potential significant revenue impact for Australian banks of aligning the domestic PE rules with those applied internationally (through OECD guidance). Without a practical alternative to *Taxation Ruling* TR2001/11[4] offered by the ATO to date, banks are principally applying OECD approaches and guidance as an appropriate (market driven proxy) mechanism for sharing profit in accordance with the business profits articles, and in addition TR 2005/11[5] provides a specific administrative solution for inter-entity loans as a practical acknowledgement that this method is equitable and fair.

It is the ABA's view (and it is an approach adopted in overseas jurisdictions such as the UK) that an application of the business profits articles using arm's length pricing methods for financial transactions between parent and branch (e.g. loans, foreign exchange and derivatives etc) as a proxy method would result in a fair reflection of profit in each jurisdiction in a manner that would effectively align with a separate entity approach. Accordingly, a move to more closely adopt the

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[1] Recommendation 22.11(a) of the July 1999 Review of Business Taxation and the Discussion Paper "Cross Border Dealings within a Single Entity", prepared by Tony Frost for the Challis Taxation Discussion Group, 5 May 2010 ('the Challis Report').

[2] Resulting from the fact that Australia currently has some specific rules which operate outside the existing transfer pricing provisions for foreign bank branches and OBUs.

[3] Which can be a division of the Australian bank itself rather than a separate legal entity.

[4] Income tax: international transfer pricing – operation of Australia's permanent establishment attribution rules

[5] Income tax: branch funding for multinational banks

OECD's functionally separate entity approach is unlikely to have a material revenue impact however it would provide greater certainty[6].

We also note that any revenue impact needs to be carefully measured, taking into account both the positive aspects as well as the negative aspects for revenue. It cannot simply be assumed that Australian tax leakage will occur. This is particularly the case for Australian based entities engaging in outbound dealings with their foreign branches.

We understand that Treasury intends to use the new International Dealings Schedule ('IDS') as a tool to gauge the proposed revenue impact for changes to the PE attribution rules. We are unclear as to how this could occur given the data which will be collated for the 2012 IDS[7].

If the IDS data is the source of material for Treasury to make an informed decision about revenue impact, the data will not be available for some time. The IDS will only apply to *all* taxpayers (not just financial services entities) for the 2012 tax year onwards. Tax returns for that income year will not be lodged for some time. As a result, even if the IDS data allows Treasury to make any assessment about revenue impact, any review by Treasury of the existing PE attribution rules is not expected to occur until 2013 and beyond. This is unhelpful to Australian banks given the continued uncertainty in relation to inter-branch treatment that has existed for many years.

In summary, not taking the opportunity to align Australia's transfer pricing treatment of PEs with international best practice (as promulgated by the OECD in its 2010 Paper on the '*Attribution of Profits to Permanent Establishments*' is inconsistent with Policy Objective 2 and gives rise to unequitable outcomes. By failing to address this issue, Australia's PE attribution rules will not be aligned to international transfer pricing standards, nor will they be aligned to the rules of our major investment partners. The ABA submits that this will have implications in terms of uncertainty for financial institutions and eventuate in a real risk of double taxation. Moreover, Australia will be at odds with major investment partners, which adopt and enforce the OECD approach to PE attribution.

While the ABA members submit that PE attribution should be addressed within the scope of the current transfer pricing review, we also recognise the comments in the Challis report with respect to a "phased" implementation approach[8] may provide an interim solution for Australian banks. In this regard, we recommend that if PE attribution continues to be treated as a separate policy concern, the issues that Australian banks currently face with respect to internal derivative transactions should be addressed via legislation so Australian banks are not disadvantaged in comparison with foreign bank branches and double taxation risk

[6] The ATO is currently reviewing established inter-branch banking practices and have released a discussion paper on inter-branch dealings that appears to adopt views that could be seen as inconsistent with OECD approaches. The use of arm's length methods for inter-branch transactions aligns with other major financial hubs (for example the UK).

[7] Based on the current draft (version 7) as at the date of this submission

[8] Refer Page 25.

is mitigated. Practically, it is submitted that this could be addressed by amending Division 230 to recognise inter-entity derivative transactions of Australian banks. The pricing of such transactions could then be dealt with through the transfer pricing rules.

Practical considerations in relation to proposed new transfer pricing rules

Application of rules for PEs

Currently, Australia's profit attribution provisions for PEs are part of, and are embedded in Australia's domestic transfer pricing law in Division 13. In this way, taxpayers are provided with transfer pricing legislation that governs dealings with associated enterprises *and* with permanent establishments, albeit that specific application provisions apply for the different entity types.

If Treasury continues to treat the transfer pricing treatment of PEs as a separate policy concern, and Division 13 is rewritten as proposed, the new legislation should be drafted so that general transfer pricing provisions apply equally to all entities regardless of the entity structure. This will ensure to the extent possible that there is consistent treatment for associated enterprises and branches.

Specifically, the ABA submits that the proposed new features for Australia's transfer pricing rules which are addressed in the Paper should equally apply to PEs as well as to associated enterprises, for example:

- Self executing application (paragraphs 69 and 70 of the Paper). Any fundamental change to the application of Australia's transfer pricing rules should apply to all entities regardless of form.
- Defined assessment period (paragraphs 99 to 104 of the Paper). The benefits of time limits for amendments should not be restricted only to transfer pricing issued involving associated enterprises.
- Removal of the Commissioner's discretionary powers (paragraphs 71 to 83 of the Paper). Similarly, the removal of the very wide discretionary powers of the Commissioner should equally benefit both associated enterprises and PEs.

We also acknowledge that other likely additions such as any statutory documentation requirements would also be expected to be equally relevant for branches and separate legal entities subject to our reservations which are set out further below.

Furthermore, the existing taxation rulings in relation to the treatment of PEs of banks should continue to apply even where some parts of Division 13 (upon which those rulings are based and are referenced to) will be re-written. For example, the ABA believes that Taxation Ruling TR 2005/11 should also continue to apply to banking PEs regardless of any change to Australia's transfer pricing provisions.

In addition, any new legislation should be drafted to readily accommodate the OECD's functional separate entity approach so that this can be easily inserted without the necessity for fundamental change to the legislation.

OECD Guidelines

In principle, the ABA supports the adoption of OECD Guidelines ('the Guidelines') in tax legislation as suggested in the Paper to the extent that the Guidelines are adopted in their current form. The ABA does not however endorse the modification of these guidelines through the incorporation of additional aspects into domestic legislation, as this is inconsistent with Policy Objective 2 and has the potential to lead to increased compliance costs and the risk of double taxation.

Specific concerns, for Australian banks are:

- The broadening of scope of the arm's length principle from pricing transactions to determining an arm's length outcome for a full range of material dealings or arrangements in place between parties (Paragraph 33);
- The prioritisation of profit based methods over traditional transaction methods (Paragraph 58);
- Comparability standards requiring the exact circumstances of the taxpayer to be taken into account (Paragraph 55); and
- The retention of residual discretionary powers for the Commissioner where there is insufficient information or reconstruction is considered warranted (Paragraph 72).

These issues are discussed further below.

Broadening of scope

The proposal in paragraph 33 seems to be that the revised rules will require the determination of an arm's length outcome for a full range of material dealings or arrangements. This is reiterated in paragraph 35 which refers to Profit Allocation rules which look at the "totality of arrangements between firms".

We submit that references to the "full range" or "totality" of dealings or arrangements go further than is required to implement the international standard concerning transfer pricing. This is a concern to Australian banks who (in line with OECD guidance) typically deal with transfer pricing on a separate transaction basis using transactional transfer pricing methods (refer also comments below). There is very good reason that they do so: it is often difficult for financial service entities to determine the overall arm's length profit allocation for each entity within their group which is attributable to inter-group dealings. Each entity in a group may comprise several business units and a combination of back, middle and front office functions and will enter into numerous transactions both with external and group counterparties. Given the diverse nature of each entity, it would be practically difficult and require significant time and effort resulting in

material compliance costs to seek to identify an arm's length 'profit' outcome for a full range of material intra-group dealings. It is important to note that financial services entities operate in a significantly different manner than other businesses which means that an overall profit outcome is not as easy to establish as it may be for taxpayers with business operations similar to those in the SNF case.

In summary, whilst it will be difficult to reliably analyse the totality of arrangements for each entity within a banking group, it is also inappropriate under OECD guidance to be required to do so *in all cases*.

Transfer pricing methods

A fundamental element in applying OECD transfer pricing guidelines is to choose the most appropriate transfer pricing method to be applied in the circumstances. The OECD does not specify a preference for one transfer pricing method over any other. The objective is to select and apply the *most appropriate* method. Given the stated policy objectives of the proposed new transfer pricing rules (and particularly the first objective of ensuring profits reflect economic activity), the ABA is concerned that a preference towards profit transfer pricing methods will be stated in or interpreted into the new rules. There is a risk that transactional transfer pricing methods will not be accepted by the tax administration and instead profit methods will be preferred regardless of whether a transactional method is the most appropriate in the circumstances. This is clearly not the purpose and effect of the OECD Guidelines concerning the application of transfer pricing methods. Moreover, this presents a practical difficulty for banks, as the availability of comparable market benchmarks for particular transactions means that traditional transactional methods such as the Comparable Uncontrolled Price ("CUP") method are often used as the most appropriate transfer pricing method, and it is often impractical to apply profit methods to internal dealings.

Comparability

There is an inference in paragraph 55 that the revised rules will legislate so that the circumstances of the taxpayer should be reviewed at all times. Whist we recognise that comparability is important and accept the five factors set out in the OECD Guidelines are relevant, the ABA agrees with the decision of the Full Federal Court in the *SNF case* that any requirement to consider the exact circumstances of the taxpayer in establishing comparability when applying traditional, transactional transfer pricing methods, would lead to impossibly high comparability requirements. This may impair the ability of Australian banks to apply the CUP method which as noted above, is often utilised in pricing inter-group transactions. This can be illustrated in considering a risk transfer arrangement for a client exposure as set out below.

In order to manage credit risk, banks will have defined credit exposure limits for particular client names, industries, geographies etc. If lending assets exceed these exposure limits, it will be necessary to mitigate credit risk which could occur (say) by entering into a credit default swap ('CDS') transaction. This could be undertaken with an external counterparty or with a group entity depending on the bank's business structure and operations. As there is ordinarily a liquid CDS

market, intergroup risk transfers would generally be priced having regard to appropriately comparable market benchmarks (e.g. applying the CUP method). However if it was necessary to consider the "specific circumstances of the taxpayer" in order to apply the CUP method, it could be argued by the Commissioner that comparability factors have not been satisfied. This is because it would be extremely unlikely to find any external transaction where the counterparty has exactly the same risk profile and concentration limits as the tested party. It is also noted that such information is commercially sensitive and unlikely to be available in the public domain.

Further to this, banks are in the business of managing risk and may also enter into transactions which do not generate profits (for example risk shifting arrangements). Would an examination of the circumstances of the taxpayer lead to the assertion that independent third parties would not enter into loss-making transactions, even if done for *bona fide* risk management purposes?

In summary, a blanket rule requiring the circumstances of the parties to be examined and compared at all times might not be appropriate to taxpayers (such as banking organisations) that often use a CUP method. Accordingly, the ABA cannot support a rule which would make the CUP method practically difficult, or in fact impossible, for Australian banks to apply.

Commissioner's Discretionary Powers

As a final matter regarding the practical aspects of the Paper, the ABA questions whether the retention of any discretionary powers in the new legislation would be contrary to a self assessment system with self executing rules. If *some* element of discretion needs to be retained, we make the following submissions:

- *Insufficient information discretion*. If the rules are intended to be self-executing, the burden on each taxpayer to discharge its responsibility under self assessment is very high. If the taxpayer has completed transfer pricing documentation that meets the standards as proposed in the new law, it is improper to allow the tax administration to choose not to accept the information provided by the taxpayer or seek to claim that it is incomplete. If it is misinformation or the information is incomplete, the obligation under self assessment will not been discharged. Moreover, if the behaviour of the taxpayer is blatant and tantamount to evasion, there are more formal and well understood measures in the tax law that will address this behaviour, without having to rely on discretion in the transfer pricing law. In the view of the ABA, there is no need for this discretionary power in a self assessment environment.
- *Reconstruction discretion*. The ABA acknowledges that the reconstruction of a transaction or dealing between associated enterprises is an avenue made available under the 2010 OECD Guidelines. However, this power of tax administrations to reconstruct deals of taxpayers is not unfettered, and the OECD acknowledges that it would only be used in the most exceptional

circumstances. It is submitted that a similar restriction be placed on this discretion of the Commissioner, if it is to be retained in the transfer pricing law going forward.

Statutory documentation

The introduction of mandatory transfer pricing documentation requirements need to be weighed up against the approach of multinational enterprises that (quite reasonably) take a risk-based approach to managing transfer pricing risk. Under such an approach, insignificant or immaterial dealings may not be documented, as to do so would be imposing a significant compliance requirement and cost that is not commensurate with the revenue risk of the dealings themselves. Similarly, the threshold to apply a *de minimus* requirement (as per paragraph 91 of the Paper) does not assist taxpayers (including banks) that will no doubt exceed the threshold for the totality of their dealings, even if they have some quite immaterial and routine dealings that make up such total amount. For the ABA, it would be preferable that the *de minimus* threshold apply to transaction categories or transactions. Mandatory documentation requirements will not lead to greater certainty, efficiency or equity. The additional compliance costs from documentation (entirely for a tax purpose) will create an additional hurdle that will discourage normal international commercial transactions that would not exist in a domestic environment.

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As outlined above, the ABA members welcome any change to the tax law that brings transfer pricing law in Australia in line with international best practice or consensus. However, the changes should seek to do so for all transfer pricing irrespective of the form of the taxpayer (associated enterprise or PE) and the changes should go no further than the international standard.

Given the stated intentions of government to promote international trade through Australia, any transfer pricing rules need to ensure that they:

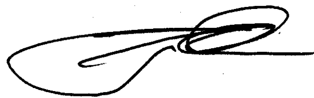
- align with current OECD guidelines;
- include within the review and rewrite branch attribution matters;
- are not retrospective in nature;
- encourage businesses and investment by ensuring they do not create additional costly compliance obligations;
- provide greater tax certainty; and
- make Australia's the transfer pricing rules consistent with that of our major trading partners.

One of the most significant aspects of the proposed changes is what is *not* being included in the changes (i.e. the PE attribution rules). In our view, updated PE attribution approaches which are aligned to the international standard (the OECD approach) ought to be a part of this exercise of modernising our transfer pricing

rules. To the extent that this is not possible, we submit that Treasury should develop an interim legislative solution (for example for internal derivative transactions) of Australian banks as well as a timetable to address the PE attribution issue in order to provide certainly to taxpayers and ensure that all stated policy objectives for the review can be achieved.

We have made submissions to the ATO about our approaches to PE profit attribution in the past. We look forward to being able to make more detailed submissions to Treasury when the PE attribution issue is addressed. To that end, and as stated above, we request advice how and when the PE issue will be included in the Treasury Work Program going forward, so that we may properly plan for more detailed submissions in future.

Yours sincerely



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