16 December 2011

Neil Motteram
International Tax and Treaties Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: transferpricing@treasury.gov.au

Dear Mr Motteram

Review of Transfer Pricing Rules – Consultation Paper Comment

The Australian Financial Markets Association (AFMA) represents the interests of over 130 participants in Australia's wholesale banking and financial markets. Our members include banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. We appreciate the opportunity to comment on the positions put in the Consultation Paper.

The key summary points in our submission are:

1. Permanent establishments should be taxed on a separate entity basis, for both foreign banks with branch operations in Australia and domestic banks with offshore branch operations;

2. A four year period for amending tax assessments should be stipulated for transfer pricing matters;

3. Proposed law amendments should not apply on a retrospective basis;

4. Removal of the LIBOR cap should be a recommendation of the review report.

1. Permanent Establishments

The Consultation Paper invites comments on the desirability of a change in the approach taken to the taxation of permanent establishments (PEs). AFMA would welcome a better alignment of Australia's taxation of PEs with international standard practice in this area.

In summary, we think the separate entity approach should be brought forward and implemented as part of a single implementation of the amendments to the transfer pricing rules. This measure would simplify the compliance with transfer pricing provisions for taxpayers. In addition, taxpayers would be able to rely on a single set of transfer pricing documentation worldwide and the law would be easier for the ATO to administer. As outlined below, having given consideration to the issues, we are not aware of any cost to tax revenue from adopting this approach for banks.

1.1. Permanent Establishments are Important as a Business Vehicle

PEs, or branches, are an important vehicle for the conduct of international business, especially in the financial sector. For example, there are 37 foreign bank branches in Australia, compared to nine foreign bank subsidiaries and 15 domestically owned banks. Each of the major domestic banks has overseas branches. PEs offer many advantages as a structure through which to conduct a financial services business; such as the ability for a financial institution to take on larger counterparty exposures, to better service multinational clients and to effectively utilise the entity's regulatory and business capital.

PEs are different from locally incorporated companies because they are not a separate legal identity from the parent (other than for tax purposes). However, PEs do have to meet certain tax and regulatory reporting requirements. For example, in Australia subdivision 820-L of the Income Tax Assessment Act 1997 requires PEs to maintain financial records, including balance sheet and profit and loss accounts, in accordance with Australian (or certain other international) standards. Similarly, APRA imposes a range of local prudential and regulatory reporting obligations on foreign ADIs.

As the Government considers the challenges and opportunities for the 'Asian Century', it is relevant to note that banks from China and elsewhere in the region are increasing their presence in the Australian banking market through PEs. It is important for the tax system to effectively serve the increasingly integrated global business environment, which ultimately will generate income and employment in Australia. Adjustments should be made over time where necessary to accommodate this objective, which will support tax revenue in Australia. Moreover, a consistent treatment of PEs is needed to foster competitive neutrality between banks that operate internationally.

1.2. Tax Policy Reviews Support Separate Entity Treatment

The Review of Business Taxation in 1999 recommended the progressive introduction of separate entity treatment of PEs:

<u>Recommendation 22.11 - General treatment of branches</u>

Progressive introduction of separate entity treatment

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

The subsequent Board of Taxation 'Review of International Tax Arrangements' Report in 2003 advised that there was wide support in submissions for a move towards separate entity treatment of branches. The Board recommended that the separate entity approach be applied to branches of foreign banks and to other financial institutions in Australia, which are subject to similar treatment to banks under the thin capitalisation rules. This recommendation was accepted by the Government and adopted in the law.

AFMA supports the position that PEs should be taxed on a separate entity basis, for both foreign banks with branch operations in Australia and domestic banks that have offshore branch operations. This approach is consistent with the principles of tax neutrality and it would be in line with the OECD approach to PE taxation, which best reflects international practice. We are not aware of any revenue cost to adopting this approach.

Part IIIB of the Income Tax Assessment Act 1936 provides substantive, though not complete, separate entity treatment of foreign banks and other financial institutions that have branches in Australia. AFMA believes that a boarder application of the separate entity approach to both inbound and outbound financial institutions would promote tax efficiency, support tax revenue, reduce tax risk and compliance costs and enhance Australia's global competitiveness. Therefore, we recommend that this approach be adopted in the law and the administration of our tax system.

1.3. Foreign Branches in Australia - Part IIIB

Technical deficiencies with Part IIIB have emerged since it was enacted in 1993; largely consequent to the evolution of the banking and financial markets since then. For example, foreign bank branches are now a significant presence in the wholesale banking market, brokers attached to foreign bank groups now account for the greater part of equities and futures trading on the Australian Securities Exchange and a raft of new products have emerged, with more likely to come as the carbon market emerges.

Consequent to these changes Part IIIB needs to be updated to cover <u>all</u> financial asset and liability transactions including securities, financial products and derivatives and not just those specified in Part IIIB. This outcome could be achieved by amending Part IIIB to recognise all intra-entity financial arrangements, as defined in Division 230. In addition, Treasury should confirm that the transfer pricing provisions also apply to notional transactions recognised under Part IIIB.

This approach would provide significant benefits for both taxpayers and the ATO by streamlining the law, improving its efficiency from an administrative perspective and removing legal uncertainty. This would also enhance the competitiveness of Australia as an international business location. Moreover, we believe that there would be no revenue cost to tax revenue to adopting this approach; for example, we understand that foreign bank branches that elect out of Part IIIB continue to apply the same transfer pricing policies. Hence, AFMA recommends that this approach should be implemented by an amendment to the law.

2. Time Limits for Amending Assessments

The absence of time limits for amendments to section 136AF or on giving double taxation relief under a double taxation agreement creates uncertainty for taxpayers and is inconsistent with the operation of amendment provisions in the domestic law. This uncertainty is of concern to AFMA members, particularly foreign and domestic banks who are subject to stringent and exhaustive regulation as holders of banking authorisations and Australian financial services licenses.

2.1. Existing Law

Under the domestic law the ATO's power to amend is limited by the general time limits in section 170. Under subsection 170(9B) the ATO may at any time make an initial amendment to give effect to Division 13 or the profit allocation provisions of a double taxation agreement. Subsection 170(9C) restricts subsequent amendments in respect of the same subject matter in relation to that year of income to a time limit of four years. Subsection 170(10), item 24, provides that there is no time limit on making amendments to give effect to consequential adjustments to assessable income or allowable deductions in accordance with section 136AF. Subsection 170(11) provides that there is no time limit on making amendments to give double taxation relief under a double taxation agreement.

2.2. Submission – General Amendment Period of Four Years

AFMA submits that to provide certainty to banks, time limits for amendments consistent with the general time limits in section 170 and related amendment sections in the Income Tax Assessment Act 1936 (ITAA) should be available for section 136AF (transfer pricing adjustments) and for adjustments to give treaty relief under a double tax agreement.

Introducing a limited amendment period for transfer pricing amendments will remove unwarranted risk and uncertainty for taxpayers and will also bring the period of assessment for transfer pricing matters in the Australian tax law in line with other comparable jurisdictions internationally.

The Government's 2005 changes to the general amendment periods prescribed the time in which the Commissioner should complete compliance activities for most taxpayers as within two years, or four years for taxpayers with more complex affairs. It is acknowledged that for tax related transactions that require more time for examination due to complexity or particular conditions, the longer period is necessary.

Transfer pricing matters are complex and a two year amendment period may not be sufficient to carry out an examination. However, notwithstanding the complexity of transfer pricing issues, an unlimited amendment period is not appropriate.

AFMA submits that the four year period of amendment would be appropriate for transfer pricing matters. The general four year period of amendment is applicable for Part IVA matters and issues examined under the general anti avoidance rules in Part IVA of the ITAA are one of the most complex and involved areas of the tax law, relying on significant factual issues and tests that need verification of information.

Transfer pricing matters are arguably no more complex than issues relating to questions under the general anti-avoidance provisions of Part IVA and on this basis the unlimited amendment period for transfer pricing matters cannot be justified. Introducing a six-year or longer amendment period from the time the Commissioner gives the taxpayer the notice of assessment, would not be justified from an internally consistent approach to taxation administration.

3. Retrospective Taxation

Certainty in the tax system is vital for taxpayers who have to make decisions on a daily basis about the structure, organisation and management of their business affairs, including financing and investment decisions. Taxpayers expect to be able to rely on the tax law as it is written and to have confidence in the fair and effective administration of the tax system. These are features of a mature governance system within an economy and they are highly relevant to the good international competitiveness of Australia as a place to invest in and to conduct business. For these reasons, the law should not be changed to operate retrospectively to the disadvantage of taxpayers unless there is an exceptional circumstance that involves serious tax avoidance.

Taking this view, AFMA supports the various industry submissions in response to the Consultation Paper that express concern that the proposed amendment to the law to clarify that transfer pricing rules in our tax treaties operate as an alternative to the rules currently in the domestic law are in effect a retrospective change to the law that will apply as far back as 2004. It appears to us that there is a consistent and strong view amongst the business community and tax advisers that the proposed change is not in the nature of a clarification but rather would amount to a retrospective change to the law. Apart from potentially imposing uncertainty and significant administrative costs on taxpayers to re-assess positions, this would create the potential for double taxation.

We understand that the intention of the retrospective application of the law is to restore the status quo. If this is the case, the retrospective application, if enacted notwithstanding the significant concerns expressed by industry bodies, must include specific provisions that will curb the Commissioner's power to re-open assessments or rely on arguments that previously would not be available to the Commissioner.

4. Concluding Comments

We believe that removal of the LIBOR cap in section 160ZZZA(1)(c) of the ITAA should have been considered in the Consultation Paper and that the review should recommend that the Johnson Report recommendation to abolish the cap be implemented immediately. This is a matter we shall take up separately.

Please contact me if you have any queries in relation to this submission.

Yours sincerely

David Lynch
Head of Policy and Markets