Greenwoods
& Freehills

Senator the Hon. Nick Sherry
Assistant Treasurer
PO Box 6022
Parliament House
CANBERRA ACT 2600

10 May 2010

Dear Senator Sherry

Cross-border dealings within a single entity

Please find attached for your information and consideration a copy of a paper on the above subject which I have recently prepared and delivered to the Challis Taxation Discussion Group of which I am a member.

For the reasons which I detail in the paper, in my opinion there is need for legislative change in the area.

I would be happy to discuss this topic with you, your advisers or Treasury and/or ATO representatives.

Yours sincerely,

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Cross-border dealings within a single entity
An area ripe for (yet more) tax reform

Tony Frost, Greenwoods & Freehills

Challis Taxation Discussion Group
5 May 2010

1 Introduction

This paper explores some of the Australian income tax[1] issues that arise when a single legal entity carries on business in more than one country via one or more permanent establishments ("**PEs**"). The paper is not concerned with whether any particular activity gives rise to a PE in the first place, nor with the taxation of a multinational group that operates via separate entities.

More specifically, the focus of the paper is on the tax implications of cross-border intra-entity dealings ("**Dealings**") that commonly occur within such a multinational entity. It can be readily acknowledged that such Dealings have no legal effect – they are the equivalent, in one sense (from the entity's point of view), of moving money or property from one pocket to another.

Despite their non-status from a legal perspective, it is evident that Dealings regularly occur inside multinational entities, and there is a practical need to consider whether, and if so when and how, Dealings have any bearing on the entity's tax affairs in each of the countries in which it conducts business. It is also acknowledged that Dealings are simply one aspect of the "correct" attribution or allocation of a multinational entity's profits and losses to each of the relevant jurisdictions in which it operates.[2]

Of course, in the current absence of a world government/global tax collector, the entity has to deal with multiple tax authorities in different jurisdictions, each of which, unsurprisingly, will have limited interest in the needs, demands and views of the others.

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[1] Unless otherwise noted, legislative references in this paper are references as required to either the *Income Tax Assessment Act 1936* or the *Income Tax Assessment Act 1997* (each "**the Act**").

[2] It is beyond the scope of this paper to consider the totality of issues surrounding such PE attribution/allocation rules, especially if the following observation is accurate! Mitchell B. Carroll, a leading early writer and thinker in this area, stated, perhaps somewhat grandly, that: "*The subject of allocation may be described as being at the cross-roads of all the sciences. It involves not only the fiscal sovereignty of States, and civil, commercial and sometimes penal law, but also commercial geography, economics, business management, and – last, but not least – accounting*": paragraph 9 of Carroll's seminal work, *Methods of Allocating Taxable Income*, vol. 4 of League of Nations, *Taxation of Foreign and National Enterprises*, Studies of the Tax Systems and the Methods of Allocation of the Profits of Enterprises Operating in More Than One Country, League of Nations document no. C.425(b).M.2176(b).1933.II.A. (Geneva: League of Nations, 1933). In short, the types of issues considered in this paper, and the broader issue of PE attribution rules, have been the subject of international focus and debate for the best part of 100 years.

The paper seeks to demonstrate that tax reforms in the area of Dealings, mooted 11 years ago[3], are indeed still required. In fact, the need for such reforms has intensified, for reasons set out in the paper. The two key reasons for early legislative action are as follows:

- Australia is now clearly out of step with the international consensus as to how Dealings should be treated for tax purposes. We are likely, in the near future (perhaps as early as later this year), to encounter disputes with potential tax treaty partners as to how Dealings are to be addressed.
- The 2009 enactment of the taxation of financial arrangement ("**TOFA**") rules in Div.230, with application for most taxpayers on/from 1 July 2010, has focussed attention on the complex Dealings of banks, and the need for clearer "separate entity" style rules in such situations, consistent with international best practice: see Examples 4 and 5 in Appendix 1 to this paper.

The structure of the remainder of the paper is as follows:

- Section 2: Parent/subsidiary vs head office/PE structures
- Section 3: Previously proposed reform to the Australian taxation of Dealings
- Section 4: OECD position on Attribution of Profits to PEs and Dealings
- Section 5: Australian response to the OECD developments
- Section 6: Current Australian tax law and ATO views referable to Dealings
- Section 7: Introduction to the Examples in Appendix 1
- Section 8: Conclusions
- APPENDIX 1: Practical examples of the application of PE attribution rules
- APPENDIX 2: Capitalisation of a foreign branch and repatriation of branch capital – a Note on some tax issues arising from fluctuations in foreign exchange rates

2 Parent/subsidiary vs head office/PE structures

Parent/subsidiary structures and intra-group transactions

At least viewed from a practical perspective, the discussion on Dealings can more usefully proceed, in the author's opinion[4], after a brief recap on the existence and tax

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[3] Neither the *Australia's future tax system, Report to the Treasurer* ("***Henry Review Report***"), December 2009, nor the initial response of the Australian Government, both released on 2 May 2010, address the issues considered in this paper, although page 157 of Part Two, Detailed Analysis states: "*Early efforts at international tax coordination centred on eliminating the double taxation of cross-border investments. Bilateral tax treaties became the primary means of reducing the risk of double taxation, and of reducing other tax barriers to cross-border investment such as tax discrimination and compliance costs. The focus of international tax coordination has now changed. Concerns now centre on the potential impacts of international tax competition and a 'race to the bottom' in company and capital income tax rates, in the face of a worldwide decline in company income tax rates in recent decades and the potential for international tax evasion.*"

[4] The author happily concedes that by starting this way, it is perhaps foreshadowing the author's personal preference, viewed from a practical business perspective, for the "functionally separate entity" approach to the taxation of PEs, over the "relevant business activity" approach; at least assuming (as seems likely to be the case for the foreseeable future) that the international community continues to stick with the arm's length standard for cross border transactions between associated enterprises. The "functionally separate entity" and "relevant business activity" approaches are discussed later in the paper. It is beyond the scope of this paper to engage in the arm's length *vs* global formulary apportionment debate.

treatment of cross-border transactions between separate but associated enterprises in situations where a multinational business operates via separate entities ("**Transactions**"). The existence of Dealings that in some situations and in some respects mimic Transactions is then noted.

In most industry sectors, and for a host of commercial, legal and tax reasons, multinational groups typically operate across international borders nowadays[5] via separate entities, i.e. subsidiaries, rather than by PEs. Where a multinational group conducts business via separate entities in different countries, many Transactions can be expected to arise between the parent company and its foreign subsidiaries (and between the foreign subsidiaries themselves), out of their day to day business activities, including but not limited to the following:

- provision/injection of share capital and possibly other types of equity by the parent into a subsidiary;
- provision of loan/debt funding, and/or guarantees/other financial support, *by the parent* to a subsidiary;
- provision of loan/debt funding of surplus funds *by a subsidiary* to its parent;
- financial derivative transactions between the parent and a subsidiary, including but not limited to forwards, swaps and options over various "underlying" risk/prices, including but not limited to interest rates, currency exchange rates, credit risk, and equity prices/indexes; and
- sales of goods/property (e.g. inventory and capital assets); use/lease/licence of goods/property; provision of services; and use of intangibles: in each case either the parent or the subsidiary could be the provider or the recipient.

Numerous tax issues of course arise from such Transactions, under domestic and international tax law; e.g. characterisation and timing issues; foreign exchange related tax-issues; application of any tax exemptions/concessions, and availability of foreign tax credits. Some of those issues would be similar to those arising in transactions by either the parent or a subsidiary with an unrelated third party. However, issues of particular focus as regards Transactions would be the operation of thin capitalisation provisions within domestic law, and arm's length transfer pricing

[5] In the early days of more modern international business (e.g. from, say, the mid-19th century) the head office/PE structure was more common than the use of separate entities. As the 20th century progressed, this pattern generally reversed, at least outside of the banking sector. For some history of the use of PEs, and the early taxation treatment thereof, see generally *Permanent Establishment: Erosion of a Tax Treaty Principle*, Arvid A. Skaar in *Series on International Taxation*, 1991, Kluwer Law and Taxation Publishers. See also Carroll, supra note 2; and Richard J. Vann *Reflections on Business Profits and the Arm's-Length Principle*, in BJ Arnold, J Sasseville and EM Zolt eds, *The Taxation of Business Profits Under Tax Treaties* (Toronto, Canadian Tax Foundation, 2003); chapter 5, pp 133-169, and references cited therein.

rules[6] within domestic law and any applicable double tax agreements ("**DTAs**"). A consideration of such rules is beyond the scope of this paper.

Importantly, properly constructed Transactions (e.g. cross-border arrangements between a parent and a subsidiary) are in fact "transactions" in a legal sense, i.e. they will ordinarily give rise to contractual rights and obligations between two separate legal entities.

Head office/PE structures and intra-entity Dealings

Notwithstanding the modern prevalence of parent/subsidiary structures, significant numbers of businesses do in fact operate internationally via PEs (or, perhaps more commonly, via a mix of PEs and subsidiaries), such that the subject matter of this paper is far from being of only academic interest.

The banking sector is perhaps the best (but by no means only) example of an industry which tends to prefer to operate, wherever possible and particularly internationally, via a single entity (head office/PE) structure, i.e. rather than via a parent/subsidiary model. The rationale for this preference is primarily related to the efficient use of capital, i.e.:

> "As a consequence of the preference for simplicity, a bank will want to operate where possible through a branch structure rather than subsidiaries. A branch will have a more efficient capital structure than a subsidiary. The notion of efficiency is about the need for capital, equity and related instruments. ***Capital requirements will be less for a branch than those of a subsidiary fostering the same kind of business***. Branch status allows a broader portfolio of risks off one larger capital base."[7] (emphasis added)

In addition, customers, particularly large corporate, institutional and government lenders/depositors to banks, will generally prefer to deal with the main entity in a banking group rather than with a subsidiary, as the credit risk will be better and it will avoid the need to ensure that full parent/subsidiary guarantees are in place for the benefit of creditors. Although banks generally prefer a PE/branch structure, there can be many reasons[8] why they end up, in practice, often holding large numbers of subsidiaries in their own country as well as internationally.

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[6] Transfer pricing rules within domestic law are to found in s.136AD and other provisions of Division 13. The primary corresponding DTA provision is to be found in Article 9 dealing with associated enterprises.

[7] Comments by the late Professor Warren Hogan from (at that time) the University of Technology, Sydney and also at that time and for many years previously a director of Westpac Banking Corporation (as set out on page 2 of his paper): "*A Perspective on the Domestic and International Pressures Influencing the Operations of International Banks*", which was presented at an ATO Workshop on the Taxation of Branches of International Banks, held in Sydney on 20 & 21 March 2001).

[8] Such reasons include: (a) regulatory/licensing requirements for particular types of business in particular countries ; (b) acquisitions/takeovers where a variety of factors (such as cost considerations, tax/stamp duty, accounting/goodwill issues, social/community concerns, not to mention a host of potential legal impediments especially relating to the transfer/novation of liabilities and contingent claims etc) may create temporary or permanent barriers to a corporate structure rationalisation; and (c) use of special purpose vehicles for particular financing

Where an entity (bank or otherwise) chooses to operate in a foreign country via a PE rather than by a subsidiary, e.g. for the reasons noted above, there will usually be commercial reasons for Dealings to arise between the head office and the PE (and between PEs in different countries), which from a commercial/economic perspective will mimic or replicate the Transactions that might otherwise be expected to have arisen, had the PE in fact been a subsidiary.[9]

For example, if an entity manufactures goods (inventory) at its head office in one country and sells them via a PE in another jurisdiction, a Dealing will arise when the head office transfers the goods to the PE. For financial accounting/record keeping purposes, as well as for management accounting and performance measurement of various business units/locations, the entity can be expected to keep accounts (e.g. profit or loss and balance sheet, amongst others) for the PE that in many respects will mimic the accounts that would be kept for a subsidiary. As part of such accounts, the transfer of the goods from the head office to the PE would be treated as if it were a "sale", with "payment" being made by the PE to the head office.

Unlike Transactions, Dealings have no legal status, but will nonetheless ordinarily involve flows of funds, goods and/or provisions of services etc between the head office in one country and the PE in another country (or between PEs located in different jurisdictions, perhaps with little or no involvement of the head office.)

The term of Dealings, as with Transactions, will vary greatly, from a matter of days to some years, depending on the Dealing and fact pattern in question.

3 Previously proposed reform to the Australian taxation of Dealings

Recommendation 22.11(a) of the (Ralph) Review of Business Taxation ("**RBT**"), in their July 1999 Final Report ("**Ralph Review Report**") was as follows:

> *"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."* (emphasis added)

The above Recommendation is yet to be implemented in any meaningful way[10]. The previous (Howard) government, which commissioned the RBT, initially supported a number of the RBT Recommendations, including Recommendation 22.11(a), "in

transactions, which may facilitate efficient and transparent control, profit ascertainment and ultimate disposition of the underlying investment.

[9] Two types of Dealings of banks are addressed in Examples 4 and 5 in Appendix 1. Achieving an early resolution of *the way* in which such Dealings (which in practice involve significant sums) should be recognised, post-Div.230, should be an early priority for the Government (ideally via legislative change, i.e. so as to provide clear "functionally separate entity" treatment) and the ATO.

[10] The limited amendments since the time of the RBT Final Report, to s.23AH and to the taxation of dividends received by Australian PEs/branches of foreign entities, do not address the wider issue of Dealings considered in this paper.

principle"[11]. That government then reaffirmed that support in 2003[12], but did not initiate any amendments. It appears that the current (Rudd) government has yet to express a view[13] on RBT Recommendation 22.11(a) dealing with separate entity treatment of dealings between a branch and other parts of the entity.

The RBT made the following comments in 1999 in support of Recommendation 22.11(a)[14]:

> *"With the exception of branches of foreign banks that are taxed under specific provisions, the current taxation treatment of branches is unclear (A Platform for Consultation, page 707). Ideally branches would be treated as separate entities so that the taxable income of the branch correctly reflects the profits attributable to the branch. This would result in a more equal treatment of branches and entities such as companies. The treatment of branches within member countries of the Organisation for Economic Cooperation and Development (OECD) is moving in this direction. However, some caution needs to be exercised in how far such an approach is implemented where there is not a consensus within the OECD.*
>
> Dealings involving trading stock
>
> *For this reason, the Review's recommendations are limited at this stage to those that are consistent with the treatment in other countries and are consistent with Australia's DTAs.*
>
> *Where trading stock is supplied to or acquired from other parts of the entity, taxable income of the branch will be determined by applying arm's-length prices to those dealings calculated as if the dealings were between unrelated entities. This change will apply to Australian branches of non-residents and to the foreign branches of residents. The transfer of other assets between the branch and the rest of the entity will not be addressed at this time as there is not an international consensus on this issue. For the same reason, withholding taxes will not be extended to intra-entity interest and royalty payments (beyond the present foreign bank branch provisions). The progress of deliberations at the OECD on the broader application of this approach to branches should be monitored and further elements of the approach could be considered if the OECD reaches consensus on other types of dealings."*

It can be seen that the RBT was expressing caution in light of emerging Organisation for Economic Cooperation and Development ("**OECD**") views, to which we now turn, before returning to a more detailed consideration of the current law and practice in Australia in relation to Dealings.

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[11] Treasurer (Costello) Press Release No 74, 11 November 1999, *The New Business Tax System: Stage 2 Response*, Attachment N.

[12] The Howard government reaffirmed its in principle support for *"rewriting the law over time to permit, in appropriate circumstances, separate entity treatment for branches"*: Treasurer (Costello) Press Release No 32, 13 May 2003, *Review of International Taxation Arrangements* ("**RITA**") Attachment G.

[13] The current Treasurer (Swan) and then Assistant Treasurer (Bowen) issued joint press release No. 53, on 13 May 2008, i.e. on the night of the Rudd Government's first Federal Budget, which stated: *"At the time the Parliament was prorogued, on 15 October 2007, the previous government was still to enact almost 60 announced tax measures. The Rudd Government has been working its way through this stock of announced but unenacted measures with a view to arriving at a decision on each of them and eliminating the considerable uncertainty that exists around them in the community. The attached table details the stock of unenacted measures, and the Rudd Government's decision on the majority of those measures."* Seemingly because RBT Recommendation 22.11(a) on branches was only supported in-principle, and never announced as an actual change, it is not addressed in press release No.53.

[14] Pages 668-669 of the RBT's Final Report.

4 OECD position on Attribution of Profits to PEs and Dealings

OECD July 2008 Report on the Attribution of Profits to Permanent Establishments

After many years of deliberation, consultation and numerous drafts, the OECD released its final *Report on the Attribution of Profits to Permanent Establishments* ("**OECD Report**") on 17 July 2008.[15] Early work in this respect was in train at the OECD, with officials from member country Australia heavily involved, at the time of the RBT's Final Report in 1999.

The controversy: how to interpret Article 7

As noted in the Preface to the OECD Report, there has been "considerable variation" in the domestic laws of OECD member countries as regards the taxation of PEs, as well as no consensus amongst members as to the correct interpretation of Article 7 (Business Profits) of the OECD Model Tax Convention on Income and Capital ("**OECD Model Tax Convention**"). The Preface went on to say that the development of global trading of financial products and electronic commerce had helped to focus attention on the need to establish a "broad consensus" regarding the interpretation and practical application of Article 7.

Paragraphs 1 and 2 of Article 7 of the OECD Model Tax Convention are currently stated (as per the 1977 Model Tax Convention) in the following terms:

> "*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.*
>
> *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.*"

Paragraph 8[16] of the OECD Report notes that two broad interpretations of Article 7(1) are currently used by OECD member countries, being the "functionally separate entity" ("**FSE**") approach and the "relevant business activity" ("**RBA**") approach. Although the different approaches may produce a similar result in a number of cases, the OECD Report states that the current lack of consensus is unsatisfactory, as it

[15] A full analysis of the detailed (263 page) OCED Report is beyond the scope of this paper. The main focus of comments in this paper is to touch on some aspects of the OECD Report as relevant to the recognition and tax treatment of Dealings. The OECD Report has 4 Parts. Part I is entitled "General Considerations". Part II contains "special considerations" as regards banks, whilst Part III has special considerations in respect of global trading of financial instruments. Part IV of the Report contains special considerations referable to insurance companies.

[16] Unless stated otherwise, all references to the OECD Report are to Part I: General Considerations.

results in a real risk of double, or less than single, taxation, especially in cases where one jurisdiction uses the FSE approach and the other jurisdiction uses the RBA approach.

The relevant business *activity approach*

Under the relevant business activity approach, the "profits of an enterprise" for the purposes of Article 7(1) are taken to be only the profits of the business activity in which the relevant PE has some participation (the "relevant business activity"). The term "relevant business activity" does not appear in either Article 7 or the Commentary but apparently emerges from country practices on interpreting what is meant by the phrase "profits of the enterprise" in Article 7(1).[17] As the OECD notes, there are in fact a number of significant differences in the way that some OECD members apply this approach.[18]

Under this approach, Article 7(1) imposes a limit on the profits that could be attributed under Article 7(2) to a PE: the attributed profits could not exceed the profits that the whole enterprise earns from the relevant business activity. The profits of the whole enterprise would be those earned from transactions with third parties and those earned from transactions with associated enterprises, the latter of which would need to be adjusted under transfer pricing rules if they did not reflect the application of the arm's length principle.[19] Dealings may have a role in attributing profits under the RBA approach, but the impact of Dealings would generally be limited by the fact that typically the profits attributed to the PE could not exceed the overall profits that the whole enterprise earns from the relevant business activity.

The functionally separate *entity approach*

As noted above, the second broad interpretation of the phrase "profits of an enterprise" is referred to as the functionally separate entity approach. The OECD Report notes as follows as at paragraph 69:

> *"Unlike the "relevant business activity" approach this approach does echo the language of Article 7(2) which states that the profits to be attributed to the PE are the profits "it might be expected to make if it were a distinct and separate enterprise ... dealing wholly independently with the enterprise of which it is a part". ... Under this approach, paragraph 1 of Article 7 is interpreted as not affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that, "the right to tax [of the host country] does not extend to profits that the enterprise may derive from that State otherwise than through the*

[17] OECD Report, paragraph 61.

[18] See paragraphs 64 to 68 of the OECD Report. Differences include how to define the "relevant business activity", the relevant time frames, and whether to apply limitations by reference to gross profits or (as seems to be the case in Australia) by reference to income and expense.

[19] OECD Report, paragraph 62.

permanent establishment", i.e. there is no "force of attraction" resulting from the existence of a PE. The profits to be attributed to the PE are the profits that the PE would have earned at arm's length as if it were a "distinct and separate" enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle under Article 7(2)."

Differences between *the approaches*

Amongst other differences[20], the FSE approach, unlike the RBA approach, does not limit the profit attributed to the PE by reference to the profit of the enterprise as a whole or a particular business activity in which the PE has participated. As a result, for example, the PE can be regarded as making a profit, even if the entity as a whole has made a loss.[21]

The "authorised OECD approach": functionally separate entity

In a brave attempt to herd the cats, the OECD has specified an "authorised OECD approach" ("AOA"), as the "preferred interpretation of paragraph 1 of Article 7", per paragraphs 9 and 10 of the OECD Report[22]:

> *"After considering the expected merits of both approaches, the OECD member countries have decided, on balance, to adopt the "functionally separate entity" approach as the "authorised OECD approach" or the preferred interpretation of paragraph 1 of Article 7.*
>
> *Accordingly, the authorised OECD approach is that the profits to be attributed to a PE are the profits that the PE would have earned at arm's length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle under Article 7(2). The phrase "profits of an enterprise" in Article 7(1) should not be interpreted as affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that "the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment" (i.e. there should be no "force of attraction principle")."*

The recognition, treatment *and pricing of Dealings under the AOA*

It is beyond the scope of this paper to summarise or comment on all aspects of the AOA, or even to comment on all of the implications of the AOA as regards Dealings.

In broad terms, Dealings have a significant role under the AOA, as can be seen in paragraph 208 of the Report (and at many other places):

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[20] Other differences are explained in paragraphs 70 and 71 of the OECD Report. Paragraph 70 states that the functionally separate entity approach permits profits to be attributed to the PE, even though no profit has yet been realised by the enterprise as a whole, for example when the PE finishes manufacturing goods and transfers them to another part of the enterprise for distribution or assembly. However, it is acknowledged that these effects may be neutralised over time. On the other hand, the relevant business activity approach has generally not regarded profits as being attributable to the PE until profits have been realised by the enterprise as a whole from transactions with other enterprises. A transfer of an asset may result in double or less than single taxation where the host and home country take different approaches to the question of whether profit can be attributed in respect of that transfer.

[21] For a more detailed explanation of the differences in the approaches, and wider commentary on Article 7 more generally, see Vann supra note 5.

[22] See also the more detailed conclusion in paragraphs 72 to 79 of the OECD Report.

> *"Where the PE has dealings with other parts of the enterprise, those dealings (provided they pass the threshold test discussed below) will affect the attribution of profits to the extent that the dealings are relevant to the functions performed by the PE and the other parts of the enterprise, taking into account assets used and risks assumed. For example, the PE may begin to use assets (tangible or intangible) belonging to the enterprise that were developed by the head office or purchased for the business of the head office or vice versa. The PE may use services rendered by the head office or vice versa. The PE may use cash earned by the head office or vice versa. The PE may manufacture goods and transfer them to another part of the enterprise, or it may sell goods manufactured by another part to the enterprise to third parties.* ***Under the authorised OECD approach, internal dealings should have the same effect on the attribution of profits between the PE and other parts of the enterprise as would be the case for a comparable provision of services or goods (either by sale, licence or lease) between independent enterprises.*** *However, the authorised OECD approach is based on the premise that the internal dealings are postulated solely for the purposes of attributing the appropriate amount of profit to the PE."* (emphasis added)

The OECD notes in paragraph 210 that there are a number of aspects to the recognition (or not) of Dealings. First, a PE is not the same as a subsidiary, and it is not in fact legally or economically separate from the rest of the enterprise of which it is a part. Second, because Dealings have no legal consequences for the enterprise as a whole, this implies a need for "*a greater scrutiny of dealings between a PE and the rest of the enterprise of which it is a part than of transactions between two associated enterprises*". In particular, there is a need for "greater scrutiny" of documentation that the enterprise should create to support the Dealing, in the absence of legally binding contracts that would ordinarily exist in the case of Transactions between separate entities. At paragraph 211 the OECD states:

> *"A dealing within a single legal entity is not something which is self-evident but is a construct, the existence of which is inferred solely for the purposes of determining an arm's length attribution of profit. Consequently, intra-entity dealings are perhaps more susceptible to being disregarded or restructured than transactions between associated enterprises."*

Paragraph 212 of the OECD Report states that the "starting point" for the evaluation of a Dealing will normally be the accounting records and internal documentation of the PE showing the purported existence of a Dealing. Under the AOA, a Dealing as documented by the enterprise will be recognised for the purposes of attributing profit:

> *" ... provided it relates to a real and identifiable event (e.g. the physical transfer of stock in trade, the provision of services, use of an intangible asset, a change in which part of the enterprise is using a capital asset, the transfer of a financial asset, etc.). A functional and factual analysis should be used to determine whether such an event has occurred and should be taken into account as an internal dealing of economic significance. And ultimately it is the functional and factual analysis which determines whether the dealing has taken place, not the accounting records or other documentation provided by the enterprise."*

The implications of the AOA will be far-reaching and will require member countries, and multinational enterprise, to come to grips with, amongst other things[23], Dealings as regards intangibles, e.g.:

> *"Even more difficult questions can arise when an intangible property that is "solely owned", say, in the head office, is provided to one or more of its PEs for use in the latter's business. For example, a PE may begin to make use of a trade intangible developed in the past by activities in the head office and exploited in the past by the head office. This situation commonly arises because of business changes, for example, the PE moving into a new business area. Under the authorised OECD approach, a functional and factual analysis of the situation might show that the* ***PE should be treated as engaging in a dealing with the head office in respect of that intangible property. Profit would be attributed in respect of this dealing by reference to comparable transactions between independent enterprises*** *(e.g. a royalty) and would depend on a functional and factual analysis of the dealing, the type of interest obtained or notional rights acquired (exclusive or non-exclusive), etc. Guidance on these issues is given in Chapters VI and VIII of the Guidelines. It is worth reiterating that, as noted in the previous section, an internal "royalty" is only one of a number of possible ways of rewarding intangible property."* (emphasis added)

Once a Dealing has been recognised, the AOA then applies the OECD's arm's length transfer pricing Guidelines (applicable to separate entities, i.e. for the purposes of Article 9 of the OECD Model Tax Convention), by analogy, so as to ensure the correct profit attribution to the PE occurs.[24] Amongst other outcomes, this will typically lead to "cost plus", or some other arm's length charge, where a Dealing involves internal services, rather than a simple allocation of costs.[25]

Foreign exchange implications *of Dealings*

The author finds it remarkable that the OECD Report is virtually silent on how foreign exchange ("**FX**") issues should be dealt with, under the AOA, in relation to Dealings. There is almost no mention of FX in Part I of the OECD Report, and few substantive references thereto in the rest of the Report.

Given the current absence of a global currency[26], in many cases FX gains/losses can be expected to arise from Dealings. That is, apart from situations where a PE and

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[23] For some complex and torturous discussion on the implications of the AOA as regards attributing capital to a (non-bank) PE, and the treatment of intra-entity funding/"interest", see paragraphs 149 to 206 of the OECD Report; and Part 2 of the Report as regards the corresponding rules for banks. As paragraph 205 notes, the potential recognition of internal interest dealings in non-financial enterprises is a "significant departure" from the then existing OECD Commentary on Article 7. A proper consideration of these important issues is beyond the scope of this paper. Another example of a novel concept is the internal/cross-border transfer of credit risk within a bank, which may be accepted under the AOA in certain situations: see paragraphs 174-184 in Part II and paragraphs 264-271 in Part III of the OECD Report.

[24] OECD Report, paragraph 217.

[25] OECD Report, paragraphs 251 to 256. The ATO's approach of requiring a simple allocation of costs (without mark-up), where a Dealing involves general management/administration, per TR 2001/11 (paragraph 5.36), is now out of step with the AOA. However, paragraph 5.36 is prefaced with the words *"Pending any future relevant developments in OECD views or Australian law ..."*

[26] The Single Global Currency Association (http://www.singleglobalcurrency.org/) is dedicated to the goal of implementing a Single Global Currency, within a Global Monetary Union and managed by a Global Central Bank, by 2024. These aims are to achieved "through education and persuasion". The Association currently has 105 members, including 3 Australians.

head office, or another PE, share a common currency (e.g. in the case of Euro zone members), or where a relevant foreign/functional currency has been adopted for tax purposes by one of the internal parties, inevitably a Dealing has to be priced in what will be a foreign currency viewed from the perspective or one or other of the PE and head office, or another PE.

Accordingly, where there is any delay in settlement for the payment of Dealings involving goods/services, or where a Dealing is analogous to a loan or derivative financial instrument, FX gains/losses can be expected to arise on settlement – but generally[27] only from the perspective of one or other of the internal counterparties. That is, if (say) a Dealing is priced in the home/head office currency, then the PE may have an FX gain/loss, at least at the time that the Dealing is settled (if not earlier, depending on the relevant timing rules), on a FSE entity basis viewed from its perspective, even though no gain/loss is perceived by the head office.[28]

Although it is (hopefully) implicit, it would have been useful for the OECD to have explicitly stated, in the OECD Report, that such an outcome is acceptable under the AOA[29], and that the AOA does not require symmetry of profit/loss outcome as between a PE and a head office. However, the author fears that the OECD's inability or unwillingness to directly address "the FX issue" may lead to ongoing confusion/disagreement between OECD members as to exactly what is in or out of scope, as regards the AOA.[30] As things stand, FX issues are also not addressed in either of the existing Commentary on Article 7, or in the latest version of the proposed new Commentary.

Hopefully, for avoidance of doubt (and given the experience and heritage of *Max Factor*), the eventual Australian response(s) to the OECD's AOA will specifically address the treatment of cross-border intra-entity FX gains/losses.

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[27] Where a Dealing involves two currencies, e.g. as will be the case with Dealings analogous to foreign exchange and currency swap transactions, both internal parties may perceive FX gains/losses.

[28] Issues of this nature were explored in a paper by Gregory May, Claire Acard, Tony Frost, Christian Kaeser, Taisa Oliveira Maciel, J. Scott Wilkie and Drew Morier: *Foreign Exchange Issues in International Taxation*, Bulletin for International Taxation, Volume 64 – Number 2 – 2010, IBFD, which contains a number of worked examples. See in particular section 2.4.1 (Hedged sale of goods to Branch). Most of the authors of the paper were members of Panel 2 that discussed the Subject of the same title as the paper at the 2009 Vancouver Congress of the International Fiscal Association.

[29] Whether/how FX gains/losses on Dealings should be accepted by the tax system of either the head office or the PE will, or at least should in the author's view, depend on the Dealing, and how any analogous Transaction between separate but associated enterprises would be treated. The most straightforward cases will involve day-to-day business, including Dealings involving movements of goods, services and at least some intra-entity loans and derivatives. Even in these situations, character (revenue vs capital vs exempt etc) and timing issues will arise. The FX issues are more complex when addressing "capital" type issues, e.g. the repatriation of earnings, or invested capital, from the PE to the head office. These issues were explored in sections 2.4.2 and 2.4.3 of the paper referred to in note 28 supra. See also Appendix 2 to this paper.

[30] An obvious real-life example is provided by the facts and decision in *Max Factor and Co. v FCT* 84 ATC 4060 ("***Max Factor***"), discussed in Example 3 in Appendix 1 to this paper. To the author's knowledge, the decision in *Max Factor* does not appear to have been considered judicially in the ensuing 26 years, nor is there any other subsequent Australian case that addresses similar issues.

In addition, and as should hopefully be evident from the Examples discussed in Appendix 1 to this paper, there is a need for clarity around the *timing* of tax recognition of Dealings generally, and not just as regards FX gains/losses.

OECD action *subsequent to the OECD Report*

The OECD is undertaking a "two track" approach to implementation of the AOA in the OECD Report, "*in order to provide tax administrations and taxpayers with maximum certainty as to how profits should be attributed to permanent establishments under both existing and future treaties.*"[31]

First, in an attempt to provide "*improved certainty for the interpretation of existing treaties* based *on the current text of Article 7*", a revised Commentary on the current version of Article 7, which seeks to include those conclusions of the OECD Report that do not conflict with the prior Commentary, was included in the 2008 update to the OECD Model Tax Convention.

Secondly, and so as to reflect the full conclusions of the OECD Report, the OECD is working on a new version of Article 7 and related Commentary, that, when finalised, are intended to be used in the negotiation of new treaties and of amendments to existing treaties.

Revised [2008] Commentary on existing Article 7 in the OECD Model Tax Convention

The revised Commentary on the current version of Article 7, seemingly in an attempt to minimise controversy, does not use loaded expressions such as "authorised OECD approach", "functionally separate entity" approach and "relevant business activity" approach. However, a preference for the "functionally separate entity" approach, especially as regards Dealings, can perhaps be gleaned from the following new aspects of the 2008 Commentary:

> "*11. As paragraph 2 is part of the context in which the [second sentence in paragraph 1] must be read,* ***that sentence should not be interpreted in a way that could contradict paragraph 2, e.g. by interpreting it as restricting the amount of profits that can be attributed to a permanent establishment to the amount of profits of the enterprise as a whole****. ... In other words, the directive of paragraph 2 may result in profits being attributed to a permanent establishment even though the enterprise as a whole has never made profits; conversely, that directive may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.*
>
> ...
>
> *18. Under the second step of that approach, the* ***remuneration of any such dealings*** *[undertaken with other parts of the enterprise]* ***will be determined by***

[31] OECD Press Release, *OECD releases final Report on the Attribution of Profits to Permanent Establishments*, 18 July 2008.

applying by analogy the principles developed for the application of the arm's length principle *between associated enterprises ...*" (emphasis added)

New version *of Article 7 and related Commentary*

The latest version of paragraphs 1 and 2 of the proposed new Article 7 to the OECD Model Tax Convention, as released by the OECD in the form of a public discussion draft[32] on 24 November 2009, is as follows:

> "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.*
>
> *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.*" (emphasis added)

The OECD has stated[33] that it expects that the new Article 7 and Commentary will be included in the next update to the OECD Model Tax Convention, tentatively scheduled for the second half of 2010.

Given the relatively modest changes to the text of Article 7 itself, a lot of the "heavy lifting", as regards the recognition of Dealings via the AOA, will have to come from the new Commentary, and from the OECD Report itself, which is referred to extensively in the proposed Commentary[34]. The proposed Commentary includes the following:

> "*7. When it approved the [OECD 2008] Report, the Committee considered that the guidance included therein represented a better approach to attributing profits to permanent establishments than had previously been available. It also recognised, however, that there were differences between some of the conclusions of the Report and the interpretation of Article 7 previously given in this Commentary. For that reason, the Committee decided that a new version of Article 7 should be included in the Model Tax Convention to allow the full incorporation of these principles.* ***The new Article, which was adopted in [2010], therefore reflects the approach developed in the Report and must be interpreted in light of the guidance contained in it.***
>
> ...

[32] Comments received on this version were released by the OECD on 28 January 2010: http://www.oecd.org/document/6/0,3343,en_2649_33747_44461574_1_1_1_37427,00.html

[33] http://www.oecd.org/document/27/0,3343,en_2649_33747_44117467_1_1_1_37427,00.html

[34] The OECD Report is effectively incorporated by reference into the proposed new Commentary, e.g. paragraph 7 of the proposed new Commentary states: "*The new Article, which was adopted in [2010], therefore reflects the approach developed in the [OECD] Report and must be interpreted in light of the guidance contained in it.*" and paragraph 17: "*The [OECD] Report therefore provides a detailed guide as to how the profits attributable to a permanent establishment should be determined under the provisions of paragraph 2.*"

15. Paragraph 2 does not seek to allocate the overall profits of the whole enterprise to the permanent establishment and its other parts but, instead, requires that the profits attributable to a permanent establishment be determined as if it were a separate enterprise. Profits may therefore be attributed to a permanent establishment even though the enterprise as a whole has never made profits. Conversely, paragraph 2 may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits. ...

29. Thus, for example, whilst ***domestic law rules that would ignore the recognition of dealings that should be recognised for the purposes of determining the profits attributable to a permanent establishment under paragraph 2*** *or that would deny the deduction of expenses not incurred exclusively for the benefit of the permanent establishment* ***would clearly be in violation of paragraph 2,*** *rules that prevent the deduction of certain categories of expenses (e.g. entertainment expenses) or that provide when a particular expense should be deducted are not affected by paragraph 2. In making that distinction, however, some difficult questions may arise as in the case of domestic law restrictions based on when an expense or element of income is actually paid. Since, for instance, an internal dealing will not involve an actual transfer or payment between two different persons, the application of such domestic law restrictions should generally take into account the nature of the dealing and, therefore, treat the relevant transfer or payment as if it had been made between two different persons."* (emphasis added)

5 Australian response to the OECD developments

There seems to have been no official/public response yet from the Australian Government, Treasury, or the Australian Taxation Office ("**ATO**"), as regards all of the OECD PE attribution activity set out in section 4 above, and what it may mean for our domestic law; the interpretation of our existing DTAs; for the drafting of future DTAs to which Australia is a party; and for the negotiation of protocols/amendments to existing DTAs.

Presumably Australia will "come on board", given that RBT Recommendation 22.11(a), set out earlier, aligns with the OECD's AOA, and given that Australian officials were heavily involved in the compilation of the OECD Report. That is, it seems a question of when (and how), rather than whether, Australia will adopt the OECD's FSE approach to PE profit attribution, in both domestic law and our DTAs. It is noteworthy that in relation to the 2008 Update to the OECD Model Tax Convention, and unlike New Zealand[35], Australia has not recorded any adverse Observations on the Commentary, nor any Reservations on the Article itself, that are relevant to the matters discussed in this paper.[36]

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[35] Our neighbours across the ditch seem to have a somewhat recalcitrant attitude to the OECD's efforts on PEs. Paragraph 74 of the revised Observations on the Commentary to existing Article 7 (as per the 2008 Update to the OECD Model Tax Convention) provides as follows: " ... *New Zealand notes that it does not agree with the approach put forward on the attribution of profits to permanent establishments in general, as reflected in Part I of the Report 'Attribution of Profits to Permanent Establishments'* ".

[36] Australia has three Reservations currently recorded on Article 7: see paragraphs 75, 76 and 82 of the Commentary on Article 7 in the 2008 Update to the OECD Model Tax Convention. The Reservation in paragraph 82, by which Australia reserves the right to include in DTAs a provision to the effect that, if information is inadequate to determine the profits to be attributed to the PE, the Competent Authority may apply domestic law provisions to the

However, the longer the delay in implementing an Australian version of the AOA, the greater the risk of multinational entities facing international double tax disputes (or of there being less than single taxation), especially given that the official Australian approach to PE profit attribution, as discussed in more detail below, is currently a variant of what the OECD calls the (now ostracised) RBA approach.

In any event, and assuming that the OECD does formally embed the AOA in a new Article 7 to the OECD Model Tax Convention (being the first change to that Article since 1977) and related Commentary later in 2010, or anytime soon thereafter, Australia will have to squarely confront "the AOA issue" in relation to any then-current or new DTA negotiations with other countries – whether as regards first-time DTAs, or in respect of revisions/replacements for existing DTAs.

6 Current Australian tax law and ATO views referable to Dealings

Domestic law

In broad terms, Australia taxes residents (individuals, companies and other entities) on worldwide income[37], but with a complex system of exemptions and foreign income tax offsets (previously foreign tax credits), in relation to certain foreign source income.[38] By contrast, foreign residents, including entities operating in Australia via a PE, are generally only subject to tax on Australian source income[39], subject to the operation of any applicable DTA. Provisions in relation to deductions generally, but not always, require some nexus to assessable income. Under domestic law, the source of income is generally determined under case law, developed in an ad-hoc way over many years, with only a few statutory source rules, aside from the provisions of Div.13 discussed below.

Apart from the (inadequate) rules in Div.13, Australia currently has few specific provisions addressing the tax treatment of Dealings, where a multinational entity (resident or *non*-resident) has a taxable presence in Australia, these being rules in relation to Australian branches of foreign banks/financial entities[40] and rules as regards offshore banking units.[41]

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enterprise, subject to certain qualifications, can be seen, in effect as a way of preserving scope for an RBA approach to apply, at least in some situations.

[37] Subsections 6-5(2) and 6-10(4).

[38] For example, s.23AH provides that foreign branch/PE income and capital gains of Australian companies is not assessable in defined situations. Other exemptions apply in other situations. Foreign income tax offsets are governed by Div.770. Residents can also be assessed on income attributed to them under the controlled foreign company rules in Part X.

[39] Subsections 6-5(3) and 6-10(5).

[40] Part IIIB of the Act, introduced in 1994, contains rules that apply to the Australian branches of foreign banks and certain other foreign financial entities. Amongst other provisions, Part IIIB has (non-comprehensive) recognition rules

Division 13 of the Act, titled "International agreements and determination of source of certain income" was introduced in 1982 and is colloquially referred to as the transfer pricing rules/regime (i.e. within domestic law, as regards cross-border arrangements).[42]

The primary relevant rule as regards Dealings[43] is s.136AE(4)[44], which provides as follows:

> *"**136AE(4) [Business carried on through permanent establishment]** Where –*
>
> *(a) a taxpayer (other than a partnership or trustee):*
>
> > *(i) is a resident and carries on a business in a country other than Australia at or through a permanent establishment of the taxpayer in that other country; or*
> >
> > *(ii) is a resident and carries on a business in an area covered by an international tax sharing treaty; or*
> >
> > *(iii) is a non-resident and carries on a business in Australia at or through a permanent establishment of the taxpayer in Australia; or*
> >
> > *(iv) is a non-resident and carries on a business in an area covered by an international tax sharing treaty and also carries on a business somewhere else in Australia at or through a permanent establishment of the taxpayer in Australia; and*
>
> *(b) a question arises whether, and if so, as to the extent to which:*
>
> > *(i) any income derived by the taxpayer is derived from sources in Australia or sources out of Australia; or*
> >
> > *(ii) any expenditure incurred by the taxpayer is incurred in deriving income from sources in Australia or sources out of Australia;*
>
> *(c) none of the preceding provisions of this section applies in relation to the determination of that question;*

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for specific types of Dealings, i.e. notional borrowings/interest (s.160ZZZ and s.160ZZZA); certain only notional derivative transactions (s.160ZZZE); certain notional foreign exchange transactions (s.160ZZZF); and, most contentiously, intra-entity withholding tax on "interest" paid by the Australian branch to other parts of the bank (s.160ZZZJ). Subsection 160ZZVA(2) provides that "... *this Part requires, in the circumstances stated in this Part and not otherwise, that the Australian branch is to be treated as if it were a separate legal entity from the bank*". Part IIIB contains inbound rules only; that is, it does not apply to Australian based banks with foreign branches/PEs.

[41] Division 9A of Part III of the Act, introduced in 1992, contains concessional/facilitative rules as regards (Australian based) offshore banking units ("**OBUs**"). The expression OBU is something of a misnomer. In broad terms, an OBU has to carry on business in Australia, but undertake transactions only with offshore persons, other OBUs, or the offshore PEs of the entity of which the OBU is a part: s.121EA. Section 121EB, titled "Internal financial dealings of an OBU", provides that where an entity has an OBU in Australia, as well as one or more other (non-OBU) PEs in Australia or overseas, those other Australian and foreign PEs are treated as being "separate persons" from the OBU, for specified purposes.

[42] It is beyond the scope of this paper to fully consider the rules in Div.13; i.e. other than as regards how it addresses Dealings.

[43] Dealings are not Transactions. They have no legal existence/recognition, and under current law have no tax status/implications in their own right. Nonetheless, they do have a role in correctly attributing *actual/third party* income/expense/profits from real Transactions, as between Australia and foreign countries, where a multinational entity operates via PEs in more than one jurisdiction.

[44] As can be seen, s.136AE(4) deals with business being carried on other than through a partnership or trust. Subsections 136AE(5) and 136AE(6) address such situations.

(d) that question, if determined on the basis of the return furnished by the taxpayer, would have a tax result more favourable to the taxpayer than the result that would occur if that question were determined in accordance with this subsection; and

*(e) **in the Commissioner's opinion**, the derivation of the income or the incurring of the expenditure is **attributable**, in whole or in part, to activities carried on by the taxpayer:*

(i) at or through the permanent establishment that is referred to in subparagraph (a)(i) or (iii); or

(ii) in the area covered by the international tax sharing treaty that is referred to in paragraph (a)(ii) or (iv);

the income or expenditure shall be deemed, for all purposes of this Act, to have been derived or to have been incurred in deriving income, as the case may be, from such source, or from such sources and in such proportions, as the Commissioner determines." (emphasis added)

The Explanatory Memorandum ("**Div.13 EM**") to the Income Tax Assessment Amendment Bill 1982, which introduced Div.13, states that:

*"Sub-sections 136AE(4), (5) and (6) are intended to deal with another set of circumstances ... that is, where a taxpayer carries on business in more than one country and, while transactions between the taxpayer and other entities are at arm's length prices (and, consequently, the Commissioner will not be applying section 136AD), **tax in Australia is reduced by the use, in effect, of internal transfer prices – e.g., between head office and branch – that differ from arm's length prices**."* (emphasis added)

It can be seen that s.136AE(4) has both inbound and outbound application. That is, it applies to a *resident* who carries on a business via a PE in a foreign country, as well as to a non-resident who carries on a business in Australia through a PE of the taxpayer in Australia.

Clumsily, the subsection requires the Commissioner to form an opinion and make a determination that the provision should apply[45], without putting any specific obligation on the taxpayer to act/lodge returns in any particular way. The Commissioner can only take action, *inter alia*, if the relevant tax return lodged by the taxpayer produces a more *favourable* result than would occur if the subsection applied. As a practical matter, it is evident that taxpayers generally seek to self-assess the application of s.136AE(4), so as to avoid or at least minimise disputes with the Commissioner at a later date, which could lead to substantial penalties being imposed.

As regards the important word "attributable" in s.136AE(4)(e), the ATO makes the following comments in the main ruling setting out its views on Australia's PE

[45] In paragraph 3.6 of Taxation Ruling TR 2001/11, the ATO states that s.136AE(4) is *"not self-operating; it is clearly discretionary – 'as the Commissioner determines'"*.

attribution rules, Taxation Ruling TR 2001/11, *Income tax: international transfer pricing – operation of Australia's permanent establishment attribution rules*:

> "*3.15 Paragraph 136AE(4)(e) limits the subsection to applying only if, in the Commissioner's opinion, some part of the relevant income or expenditure is attributable to the activities conducted at or through the PE. Paragraph 136AE(4)(e) differs from preceding paragraphs as it requires, and is sufficient, that the Commissioner reach an opinion as to certain facts.*
>
> *3.16 'Attributable' in this context has the same meaning as under the business profits article. The OECD Commentary on Article 7 states that the approach to the attribution test preferred by most countries focuses on where the profits are generated, that is whether they are generated through the PE. This will be so where, in substance, the resources and activities at the relevant place are the source of the profit.*
>
> *3.17* ***An examination of the separate 'sources of profit' (income and expenditure under subsection 136AE(4)) in this context does not revolve around the judicial source rules. For the purposes of paragraph 136AE(4)(e), the*** *Commissioner* ***may properly form the opinion that income or expenditure is attributable in whole or part to a PE on the grounds of commercial and economic reality.***
>
> *3.18 Accordingly, income is attributable to activities conducted at or through a PE to the extent that those activities are, in substance, a contributing factor in generating the income or give rise to benefits from expenditure incurred.*" (emphasis added)

Importantly, where s.136AE(4) applies, s.136AE(7) provides "relevant matters in determining *source*", that is, in determining what is or is not "attributable"[46]:

> "***136AE(7) [Relevant matters in determining source]***
>
> *In the application of the preceding provisions of this section in determining the source or sources of any income derived by a taxpayer or the extent to which expenditure incurred by the taxpayer was incurred in deriving income from a particular source or sources, the Commissioner shall have regard to:*
>
> *(a) the nature and extent of any* ***relevant business*** *carried on by the taxpayer and the place or places at which the business is carried on;*
>
> *(b) if any* ***relevant business*** *carried on by the taxpayer is carried on at or through a permanent establishment –* ***the circumstances that would have, or might reasonably be expected to have, existed if the permanent establishment were a distinct and separate entity dealing at arm's length with the taxpayer*** *and other persons; and*
>
> *(c) such other matters as the Commissioner considers relevant.*" (emphasis added; and note the use of the expression "relevant business")

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[46] The Div.13 EM provides that: "*Sub-section 136AE(7) sets out the criteria to which the Commissioner is to have regard in determining the source or sources of any income or the extent to which any expenditure was incurred in deriving income from a particular source or sources. The Commissioner is to have regard firstly, to the nature and extent of any business activities of the taxpayer and the place or places at which the business was conducted - that is, to the taxpayer's actual circumstances including the degree to which it operates in one country or another. Secondly, and most importantly, in a case where business is carried on by a taxpayer at or through a permanent establishment, the Commissioner must postulate the circumstances that would have existed, or might reasonably be expected to have existed, if the permanent establishment were a distinct and separate entity dealing at arm's length with the taxpayer and other persons. This basic principle is in provisions included in each of Australia's double taxation agreements for determining the amount of profits of an enterprise that are to be attributed to a permanent establishment. Lastly, the Commissioner is to have regard to other relevant matters.*"

One consequence of s.136AE(4) being applied is that it will change what income is regarded as being sourced in Australia, and what income may be sourced overseas and potentially non-assessable non-exempt ("**NANE**") under s.23AH: this issue is explored further in the Examples in Appendix 1.

Further views of the ATO as regards s.136AE(4), as set out in TR 2001/11, include the *following*:

> "*1.8 The critical difference between section 136AD which deals with separate entities and subsection 136AE(4) is that the latter takes income and expenditure as calculated under other provisions of the ITAA as given, and by appropriate sourcing of that income or allocation of that expenditure aims to produce outcomes that accord with the arm's length separate enterprise principle.* ***It does not create income or expenditure but takes them as given from the rest of the ITAA.*** *On the other hand, the deemed arm's length consideration under section 136AD can give rise to income or expenditure that would not arise under other provisions of the ITAA. In other words, subsection 136AE(4) applies the arm's length principle indirectly while section 136AD applies it directly.*
>
> *1.9 The express language of subsection 136AE(4) centres on the phrases 'income derived by the taxpayer' and 'expenditure incurred by the taxpayer'.* ***Such amounts to which a question of source arises and in respect of which the Commissioner may make a determination are clearly references to the actual income and expenditure of the taxpayer under Australian law, not an amount of notional or deemed income or expenditure.***
>
> *1.10 The only case in Australia which squarely raises this issue is Max Factor and Co. v. FC of T (84 ATC 4060), which* ***supports the view that 'transactions' between head office and PE are disregarded in determining income derived or expenditure incurred.*** *There, a United States company with a PE in Australia incurred a currency fluctuation loss in transferring funds from Australia to United States. The funds were reimbursement for the cost of raw materials provided by head office to the PE. While internally the funds were treated as payment for the cost of purchases, it was held that they were really a repatriation of capital as there was no legal liability to be discharged. As a result, the currency fluctuation loss claimed as a deduction was disallowed.*" (emphasis added)

It is fairly clear from the comments above, and even clearer in light of the ATO's comments in TR 2001/11 noted below as regards the operation of our DTAs, that the ATO's current approach to our PE attribution rules is along the lines of what the OECD would call a RBA approach, rather than a FSE approach.

As will be demonstrated in the Examples included in Appendix 1 to this paper, although *Dealings* are not themselves recognised under the ATO's approach, they may have a role in attributing an entity's *actual*/third party income and expense items, as is reflected at various places and examples in TR 2001/11, including the following:

> "*4.6 It is normal commercial practice for some form of separate accounts to be kept for a PE.* ***These may treat internal transfers as if they were transactions with external parties. Where separate accounts have been prepared in accordance with proper accounting practice they may be a starting point*** *for constructing an economic model of the PE for tax attribution purposes, depending on the segmentation adopted and the characteristics to be attributed to the PE.*

4.15 It may be seen from this discussion, that the broad methodology for dealing with PE attribution issues is to answer each of the following questions:

...

- *Do the segment accounts allocate actual income, expenditure and other items correctly having regard to the functions carried out, the assets used and the risks assumed? If not, what is the underlying cause? It may be necessary to correct the 'primary' income, expense, asset, liability and capital allocations if that is the problem;*

...

4.16 After possible correction to segment accounts for primary allocation issues, ***the valuation of intra-entity dealings is at the heart of the attribution issue. Treating intra-entity dealings as analogous to separate entity dealings enables the use of accepted arm's length transfer pricing methodologies.***" (emphasis added)

But, note the following, that shows the limitations on the use of even arm's length prices for Dealings, in light of the ATO's RBA-type approach to PE attribution:

> "*4.43 The use of some of the accepted transfer pricing methods (e.g., Comparable Uncontrolled Price (CUP), cost plus and resale price methods) in this context [selection of the most appropriate methodology for attribution purpose] should bring into account the relationship of the internal dealings, to which the arm's length pricing methodology is applied, to third party dealings.* ***This is necessary to ensure that the arm's length price for an internal dealing does not imply income in excess of that derived by the entity from an associated dealing with a third party.***" (emphasis added)

Paragraph 4.43 of TR 2001/11 is jarring – arm's length methods can be used, but only if they don't cause an awkward problem of attributing to the PE more than the "real" third party income of the enterprise as a whole.

Australia's DTAs

Australia more or less follows the OECD Model Tax Convention when negotiating new or *revised* DTAs, including as regards Article 7 dealing with business profits. Given the way that the ATO interprets Article 7 in our DTAs, as noted below, the ATO view (at least prior to the OECD Report in 2008) is that the differences in practice between the application of s.136AE(4) and the relevant DTA, where a treaty country is involved, will be "minimal".[47]

In TR 2001/11 the ATO states:

> "*1.15 Despite the differences in purpose and drafting, the rules in the DTAs do not displace the operation of ordinary domestic rules about when income and expenditure*

[47] Per paragraph 3.7 of TR 2001/11. An examination of the interaction between the rules in Div.13 and Australia's DTAs is beyond the scope of this paper. In TR 2001/11 the ATO makes the following comments: "*2.1 The business profits article, in common with other treaty provisions, incorporates relevant Australian domestic tax law by operation of the International Tax Agreements Act 1953. Thus, it sits alongside the provisions of section 136AE under the legislative framework: s.4(1) of the International Tax Agreements Act 1953. 2.2 Potentially, in treaty country PE situations, both the business profits article and subsection 136AE(4) attribution rules may apply. In the event that the outcomes of the application of each are inconsistent, the result under the business profits article prevails: s.4(2) of the International Tax Agreements Act 1953. 2.3 The business profits articles of DTAs are self-operating and take precedence to the extent that they are inconsistent with the ITAA. In the ATO's view, this means that a determination under subsection 136AE(4) is not necessary where a DTA applies before issuing an amended assessment. For reasons noted below, however, a determination would normally be made.*" See also Taxation Ruling TR 2001/13 (Income Tax: Interpreting Australia's Double Tax Agreements).

are to be recognised for tax purposes. ***DTAs do not require Australia to depart from its basic approach of allocating actual income and expenditure and do not require us to recognise income or expenditure as being generated through dealings between a head office and PE.***

...

1.17 This position is supported by the Max Factor case referred to above which involved the previous United States convention. The court concluded that the provisions of the tax treaty did not produce the result that the exchange losses of the Australian PE on transfers of funds to the head office were deductible in computing the industrial and commercial profits of the PE.

...

1.20 ***The ATO does not accept that the business profits article in Australia's tax treaties operates on a strict separate entity basis****. Further, there are foreign decisions to the same effect. ...*

1.21 The Ralph Report recommended a progressive introduction in appropriate circumstances of separate entity treatment in Australia: Recommendation 22.11. The Ralph Report also notes that some caution needs to be exercised in this direction where there is no consensus within the OECD." (emphasis added)

In coming to these views, the ATO referred (in paragraphs 1.16 and 1.18 of TR 2001/11) to the 1977 version of Article 7 of the OECD Model Tax Convention and related Commentary, which, as discussed earlier in this paper, are likely to be substantially superseded either later this year, or some time in the near future. In relation to paragraph 1.21 of TR 2001/11 noted above, and as set out in section 4 of this paper, the OECD (with the notable exception of New Zealand!) can now be regarded as having achieved a "consensus"[48] on the relevant issues.

Even before the need later this year, or soon thereafter, to grapple with a new Article 7 and related Commentary, a question may arise as to the relevance and application of the *current* (2008) OECD Commentary, extracts from which were set out earlier, in the case of any double tax dispute with a DTA partner as regards Article 7. Given that Australia has not recorded any Observations on the Commentary, nor any currently relevant Reservations on the Article itself, there is potential for conflict between the somewhat-pro-FSE approach in the latest version of the Commentary on Article 7, and the firmly-RBA approach in TR 2001/11.

Where any double tax dispute arises, and there is a need to consider/interpret Article 7 on business profits in a relevant DTA, the simpler case will be situations where the DTA in question has been concluded *after* the 2008 update to the OECD Model Tax Convention and related Commentary, e.g. in the case of our recent DTAs with New Zealand and Turkey, amongst others. In such a case, there is now ample judicial

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[48] According to the Macquarie Dictionary, "consensus" means "*general agreement or concord; majority of opinion.*"

authority for resorting, in at least some situations, to pre-existing versions of OECD Commentaries.[49]

The more interesting, and potentially more common, situation is where there is a need to interpret a DTA concluded *before* the 2008 update to the OECD Model Tax Convention and related Commentary.[50] Of course, most of Australia's current DTAs fall into this category.

7 Introduction to the Examples in Appendix 1

The five Examples in Appendix 1 seek to explore various practical issues that arise from the interpretation and application of Australia's current PE attribution rules. Hopefully, the Examples will also offer some guidance as regards the necessary legislative (and DTA) amendments needed in the area of Dealings.

The Examples are as follows:

- Example 1: outbound trading stock (simple facts)
- Example 2: inbound trading stock (inter-company facts)
- Example 3: inbound trading stock (intra-entity facts)
- Example 4: outbound intra-bank loans
- Example 5: cross-border intra-bank currency swaps

Of course, the chosen Examples address only a small sample of the range of Dealings that can typically be found within multinational entities. Note, once again,

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49 Lindgren J provides a good summary in *Undershaft (No 1) Limited v Commissioner of Taxation* [2009] FCA 41 (3 February 2009) from paragraph 43: "*In* Lamesa Holdings BV v Federal Commissioner of Taxation *(1997) 97 ATC 4229, which, like the Second Proceeding, concerned the Netherlands Agreement, the primary judge accepted (at 4,237), on the basis of expert evidence, that the supplementary material relevant to construction of the Netherlands Agreement was the* 1977 OECD Model Double Taxation Convention on Income and Capital *which included as Annex I "Model Convention for the Avoidance of Double Taxation with respect to taxes on Income and Capital" (Model Convention) and as Annex II "Commentaries on the Articles of the Model Convention) (Model Commentary) because they had been "largely formulated and published" before the conclusion of the Netherlands Agreement. Neither party submitted that the Model Convention or the Model Commentary was not able to be taken into account as relevant to the construction of the Netherlands Agreement, and indeed, the Commissioner submitted that the Netherlands Agreement must be construed in light of these documents. ...Authority for resort to extraneous materials of the kinds referred to may be found in* Thiel *at 344 (per Mason CJ, Brennan & Gaudron JJ), 349 (per Dawson J), 357 (per McHugh J);* Unisys Corporation Inc v Federal Commissioner of Taxation *2002 ATC 5146 at [44]; and Commissioner* of Taxation v Lamesa Holdings BV *(1997) 77 FCR 597 (Lamesa) at 604.*"

50 In Taxation Ruling TR 2001/13 (Income Tax: Interpreting Australia's Double Tax Agreements), the ATO states at paragraph 106 that "*There is some debate over whether subsequent changes to the OECD Commentaries should be used as an aid to interpretation of earlier DTAs. ...*" The ruling then considered (in paragraphs 106 to 108) the existing case law and other aspects of the debate at that time, including the views of the OECD itself. Subsequently, the Full Federal Court (Hill, Sundberg and Stone JJ) discussed this situation in *McDermott Industries (Aust) Pty Ltd v FCT* 2005 ATC 4398 at 4406 (paragraphs 41 and 42): "*An examination of the historical background to the relevant articles of the Singapore Agreement assists in understanding the policy issues which those articles reveal. A useful starting point is the commentary to the* draft OECD Model Convention for the Avoidance of Double Taxation with respect to Taxes on Income and on Capital, *presented in 1963 ("OECD Model Convention"), which has served as a model for many although not all of Australia's double tax agreements. Certainly the commentary has been used to assist in the interpretation of double tax agreements based upon it, although* ***there may be a theoretical difficulty in using commentary published after the adoption of a double taxation agreement as relevant to the construction of that agreement.*** *Hence, the High Court of Australia in* Thiel *had regard to the commentary to the 1977 OECD Model Convention in construing the business profits article in the Swiss-Australian double taxation agreement.* ***Whether there may be a different result in taking into account commentary published after ratification of an agreement is not a matter that need concern us here,*** *cf: John F. Avery Jones et al, "The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model (Pt 2)" (1984)* British Tax Review *90, fn 27, where* ***reference is made to examples from the Netherlands where a particular interpretation of an article was justified by a subsequent commentary.***" (emphasis added)

that Dealings are not Transactions. They have no legal existence/recognition, and under current law have no tax status/implications in their own right. Nonetheless, they do have a role in correctly attributing *actual/third party* income/expense/profits from real Transactions.

Apart from the obvious issue of seeking to divine the "correct" attribution of income/expenses, there are a number of common factual features ("**Features**") that are generally explored in the Examples, as follows:

- **Time frame**: over what period of time do the facts occur? Do the facts straddle a tax year end and what are the consequences?
- **Dealing**: is there in fact any relevant Dealing(s) recognised by the entity? That is, does the entity treat a relevant activity in an analogous way to a Transaction, with Dealing-specific remuneration "paid" for the goods/service/activity in question? Is it priced on an arm's length basis (assuming that the internal parties were in fact separate entities)?
- **Currency**: in what currency do relevant transactions/Dealings occur? Do FX gains/losses arise and how/where are they/should they be recognised?
- **Tracing**: in practical/compliance terms, is it possible to trace/match Dealings to actual third party Transactions? If not, what are the consequences?
- **Trading profile**: does the entity make overall gains/losses from the activity in question, and what are the consequences for any relevant Dealings, especially if there are overall losses?

Not all of the above 5 Features, and the variations that may arise, are considered in each Example.

The discussion in the Examples in Appendix 1 generally refers to the PE attribution rule in s.136AE(4). Identical or similar results should generally arise where the facts involve a DTA country – at least in view of the way that the ATO interprets Article 7.

8 Conclusions

Dealings are not Transactions. They have no legal existence/recognition, and under current law have no tax status/implications in their own right. Nonetheless, they do have a role in correctly attributing *actual/third party* income/expense/profits from real Transactions, as between Australia and foreign countries, where a multinational entity operates via PEs in more than one jurisdiction.

The way in which Australia currently treats/recognises Dealings for such attribution purposes is unsatisfactory. As this paper has sought to demonstrate, the Australian approach in our domestic law as regards PE attribution rules, and our interpretation of our existing DTAs (being a version of the "relevant business activity" approach) is now out of step with the international consensus, which is based on applying the "functionally separate entity" approach. Dealings are recognised and treated differently under each of the RBA and FSE approaches. We are likely, in the near future, to encounter disputes with potential tax treaty partners as to how Dealings are to be addressed in new DTAs, i.e. as/when the OECD publishes a new version of Article 7 of the OECD Model Tax Convention – currently scheduled for later this year.

Notwithstanding that the treatment of Dealings did not feature in the recent Henry Review Report, some early legislative change to our domestic law should be made, along the lines suggested in the Ralph Review Report in 1999. That is, our domestic law should be amended to provide for clear "*separate entity treatment of dealings between a branch and other parts of the entity*" (RBT Recommendation 22.11(a)). Making this change in our domestic law will pave the way for Australia to adopt a consistent approach in our new DTAs under the proposed new Article 7.

The Ralph Review Report recommended that such separate entity treatment "start with" the supply or acquisition of trading stock. That is, the changes were (apparently) to be phased in. In the author's view, it would be better (and more consistent with the new OECD Article 7) for there to be one legislative change which is comprehensive in nature.

If for some reason a "phased" approach is to be adopted, then the area of greatest current need (and thus deserving of first priority for legislative action[51]) would appear to be Dealings of banks, and not Dealings involving physical trading stock.

In practice, banks have generally recognised many forms of arm's length-priced Dealings for tax purposes (i.e. as part of the process of attributing actual income/expenses/profits from Transactions), over many years – Examples 4 and 5 in Appendix 1 highlight merely two types. In so recognising Dealings for this attribution process, banks will have generally applied tax accounting (timing) methods

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[51] So as to ensure parity of treatment of Dealings and Transaction (and to avoid potentially major distortions in the calculation of bank taxable incomes), any legislative change (whether comprehensive or bank Dealing specific) should specifically allow for pre-existing Dealings to be treated as Transactions for the purposes of the un-grandfathering rule applicable for Div.230 purposes. That is, where an entity elects to apply Div.230 to pre-existing transactions, any existing timing difference between the pre and post TOFA treatments is spread over the first 4 years to which the TOFA regime applies: Subitems 104(12) to (19) of the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009*.

consistent with the methods applied to third party Transactions analogous to the type of Dealing in question.

The recent enactment of the TOFA rules in Div.230, that first start to apply to most taxpayers from 1 July 2010 has focussed attention on the complex Dealings of banks, and the need for clearer "separate entity" style rules in such situations. In short, where the elective financial reports method applies to Transactions, then in order to achieve sensible tax outcomes for the bank as a whole, the same timing methodology should be applied, on a functionally separate entity basis, to analogous Dealings.

Legislative reform to address Dealings should be mindful of, and cater for the various attributes of Dealings, including the Features set out above – especially but not only in relation to FX gain/loss issues. It would be helpful for the OECD to provide some further international guidance on this Feature.

* * * * *

APPENDIX 1

Practical examples of the application of PE attribution rules

Note (relevant to all Dealings in all the Examples): Dealings are not Transactions. They have no legal existence/recognition, and under current law have no tax status/implications in their own right. Nonetheless, they do have a role in correctly attributing *actual/third party* income/expense/profits from real Transactions.

Example 1: outbound trading stock (simple facts)

Facts and Features

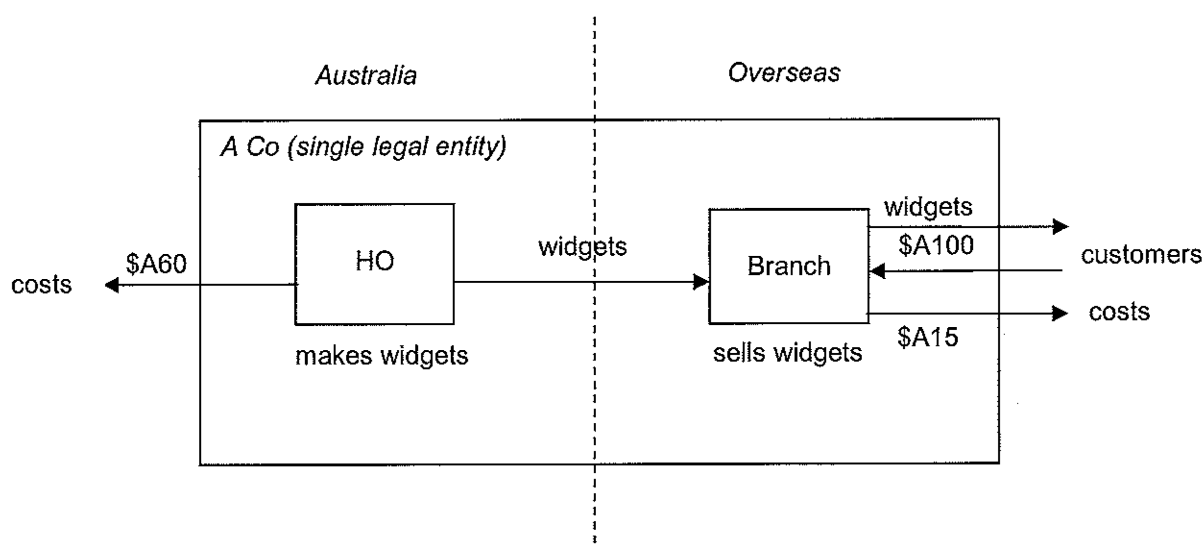
To get us started, consider the admittedly somewhat simplistic/unrealistic facts:

- An Australian resident company ("**ACo**") has an overseas PE ("**Branch**"), the income of which is non-assessable non-exempt in Australia by virtue of s.23AH. ACo manufactures widgets at its Australian head office ("**HO**"), which it then distributes, both in Australia and in other countries, including the country in which Branch, which performs sales/distribution functions, is located. Assume Australia does not a DTA with the country in which Branch is located.

- HO transfers a quantity of widgets to Branch that have a fully absorbed cost to HO of an $A60. Branch has local distribution costs of $A15, and is able to promptly sell all of the widgets for $A100.

- HO would typically sell that type of widgets, in that quantity, to third party distributors in Australia and other countries for $A80.

The facts can be represented diagrammatically as follows:



Initially, we have the simplest settings for the Features, as follows:

- **Time frame**: assume all the relevant facts occur within the same tax year, and with no difference between HO's tax year and Branch's foreign country tax year.

- **Dealing**: assume that ACo does not maintain any records to distinguish Branch from HO. Further, there is no specific "payment" from Branch to HO for the widgets in question. Branch remits its profits to HO from time to time, but such transfers are not linked to specific sales receipts.

- **Currency**: all income and expense items are denominated in $A.
- **Tracing**: assume that clear tracing within ACo can/does occur as regards the widgets in question.
- **Trading profile**: ACo makes an overall profit from the activity in question of $A25, i.e. $A100 sales income, less total costs of $A75, (HO costs of $A60 and Branch costs of $A15.)

Tax implications

ACo has been advised that "you can't recognise internal deals because of *Max Factor*." As a result, ACo lodges an Australian tax return which discloses no net Australian taxable income. ACo thinks that it has $A100 of NANE income in Branch, total related non-deductible costs in Australia and Branch of $A75, resulting in no Australian tax liability. This would be a mistake.

Presumably, on the facts given, the Commissioner would be likely to invoke s.136AE(4), on the basis that, having regard to the matters in s.136AE(7), the relevant/actual income of $A100 is only partly attributable to the activities carried on by Branch, i.e. given that the widgets were made, and value was added, in Australia.[52] The Commissioner may seek to assert that ACo has (assessable) Australian source income of $A80, and that Branch has (NANE) income of $A20 – based on the seemingly available comparable uncontrolled price of $A80 for an analogous actual transaction. That is, $A80 of the actual income is attributed to Australia in light of the manufacturing activity conducted in Australia.

In such a case, ACo will have taxable income in Australia of $A20, i.e. $A80 attributed income, less the HO costs of $A60. Branch will have non-deductible expenses of $A5 against s.23AH NANE income of $A20.

The Commissioner can seek to apply s.136AE(4) whether or not ACo recognises any Dealing as regards the internal transfer of the widgets. Further, in applying s.136AE(4), the Commissioner seeks to attribute actual/third party income (i.e. some part of the $A100 sales income), and does not recognise any Dealing as such (assuming that the entity did in fact recognise a Dealing which it priced internally as if it was a transaction between separate entities.) This application of s.136AE(4) does not conflict with the decision in *Max Factor*, at least for the simple reason that the relevant facts in that case occurred before s.136AE(4) was enacted/effective.[53]

Things become somewhat more complex/uncertain if we start changing some of the five Features set out earlier.

1. Time frame. Assume firstly that the time frame is different, and extends over more than one tax year. That is, assume that HO has transferred the widgets to Branch, but they are still on hand at Branch at the end of that year. Assume also that ACo actually recognises a Dealing and that Branch has "paid" $A80 (an arm's length price) to HO for the stock during the year. No difficulty would arise under an FSE approach: HO would be taken to have derived $A80 of income, notwithstanding that the stock had not left ACo as a whole. However, much difficulty occurs under a RBA approach, as used in Australia, as evidenced by the three pages of discussion in TR 2001/11 – see the example and commentary in paragraphs 5.5 to 5.16, including the following:

> *"5.10 If an entity carries on business through a PE, trading stock on hand may be transferred internally prior to sale. For instance, the PE may carry on a wholesaling function. It acquires stock from arm's length suppliers then transfers it to a retailing segment of the entity in other countries. Under separate accounts for the PE, items of*

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[52] See Example 2 in paragraphs 4.66 to 4.72 of TR 2001/11, that has some similarities to Example 1 in this paper.

[53] Division 13, including s.136AE(4), was enacted in 1982. The decision in *Max Factor*, handed down in 1984, concerned facts occurring in the years ended 30 June 1976 and 1977. There are also factual and tax technical differences as between this example (outbound stock) and the facts in *Max Factor* (inbound stock).

stock may be treated as no longer on hand at the point of transfer and profit then recognised having regard to (say) an internal transfer price. ***Even if the internal transfer price reflects the arm's length value of the goods, this will not correctly allocate profits between the PE and the other segments if the stock remains on hand in the retail segments at year end. ...***

5.15 In this simple case, there is ***an apparent conflict between the allocation process required by Australian law (which will only recognise income for head office and PE in the second year) and a strict application of the arm's length separate enterprise principle*** *which would seem to require recognition of the wholesale profit in the first year and the retail profit in the second.*

5.16 There are, however, ***practical problems*** *in the way of treating all profit as arising in the second year. Where the stock being moved between PE and head office is raw material or components for use in a manufacturing process at the head office and the head office is drawing similar materials or components from all over the world,* ***it becomes practically impossible to trace the particular inputs*** *drawn from one PE into the sale of the finished product. Indeed, even in the case of the transfer of finished goods between head office and PE, tracing becomes difficult in many cases, such as where the countries involved use different accounting and tax conventions for trading stock (e.g., one uses FIFO and the other last in, first out (LIFO)).* ***As a result, it may be necessary to fall back on the accounts and account for income and/or expenditure on the basis of the transfers in the accounts and not the actual revenue or expenditure involving third parties. The above solution reflects the practical problems. The Ralph Report recommends that law changes in appropriate circumstances to permit the separate entity treatment start with the supply or acquisition of trading stock. Pending possible clarification through implementation of these recommendations, where these kinds of problems arise, the practice will be to accept the position reflected by accounts prepared on a separate entity basis,*** *on the proviso that they have been properly prepared and the attribution outcomes are the best estimate of PE profits that can be made in the circumstances."* (emphasis added)

In other words, as a practical matter, it does appear acceptable to the ATO, in certain circumstances, to effectively recognise income/expense from Dealings, rather than the actual revenue or expenditure involving third parties.

2. Dealing. As noted above, whether or not ACo actually recognises/prices a Dealing (along arm's length terms) is irrelevant to the application of s.136AE(4). A taxpayer can minimise the risk of adjustment under s.136AE(4) by seeking to recognise and properly price internal cross-border Dealings.

3. Currency. The extra complexities that arise where foreign currency is involved are explored in Examples 2 and 3 below.

4. Tracing. Realistically, especially in high-volume businesses, it may not be possible to precisely trace goods so as to match up income and expense items, as is acknowledged in paragraph 5.16 of TR 2001/11 noted above. The pragmatic approach taken in TR 2001/11, as regards "aggregation" (see discussion below on Trading profile) is also on point.

5. Trading profile. As noted above, ACo makes an overall profit of $A25 from the activity in question, given the ultimate sale price of $A100.

Assume now that the Branch can only sell the widgets for $A50 (e.g. due to sudden obsolescence etc), but that at the time the widgets were transferred by HO they had an arm's length value of $A80. No great difficulty arises in such a situation under a FSE approach: HO has intra-entity sales income of $A80, and will thus have a gain of $A20, while Branch will have a loss of $A45 (given third party sales income of $A50, less intra-entity cost of goods of $A80 and its own costs of $A15.)

Once again, a RBA approach in such a situation leads to messy practical implementation, given that (in theory) it is not possible to attribute more than the actual third party income of $A50 to HO, as evidenced in paragraphs 4.71 and 4.72 of TR 2001/11:

> *"4.71 A potential problem with having regard to accepted arm's length pricing methodologies for allocation of income between a PE and head office, is that* ***in some circumstances, the income to be allocated may be insufficient to justify the internal transfer price****. For instance assume the goods in the example had been accidentally damaged while held by the PE and not covered by insurance. The PE is only able to sell them for $40 because of the damage. It is no longer possible to allocate $60 to the head office because this figure exceeds the actual income (the sale price).* ***What amount is allocated to the head office would depend on the circumstances****, but assuming that $60 reflects an appropriate transfer price at the time the goods are transferred between head office and PE, that amount may be the whole of the $40 sale price. Such an allocation of income and related expenditure would leave the PE with a loss of $20 and the head office with a break-even result.*
>
> *4.72* ***It follows from the ATO view that the allocation of income and expenditure will not produce the same outcome as the arm's length separate enterprise principle whenever the ultimate sale price is less than the transfer price. This situation is likely to be rare in practice.*** *Moreover, the principles concerning aggregation of transactions will often mean that the effect of individual transactions where the ultimate sale price is less than the transfer price is outweighed by other transactions where the sale price exceeds the transfer price.* ***Where aggregation is appropriate under arm's length principles, the ATO considers that the allocation of income and expenditure approach does not require disaggregation for the application of Australian domestic tax law.****"* (emphasis added)

In other words, as a practical matter, hopefully the problem is "rare" and can be effectively glossed over by aggregating loss making transactions with profitable ones.

Example 2: inbound trading stock (inter-company facts)

Facts and Features

As a precursor to a more detailed/realistic example of an intra-entity transfer of trading stock (in Example 3 below), the following Example considers the tax implications where the facts involve a parent/subsidiary, rather than a head/office branch – so as to provide some yardstick for/comparison of tax outcomes.

The facts are as follows:

- A US based multinational ("**USCo**"), involved in the manufacture and sale of women's cosmetics, has an Australian wholesale subsidiary ("**AusSub**"), which imports/distributes products to Australian retailers that have been manufactured by USCo, or other members of the group.
- AusSub acquires a shipment[54] of cosmetics from USCo, and is required to pay the $US1 million (arm's length) purchase price 90 days after delivery. USCo sells all of its products to related and unrelated parties in $US and allows all such purchasers a 90 day payment period. The manufacturing cost to USCo of the products sold to AusSub is $US0.6 million.
- AusSub sells the cosmetics imported from USCo, to Australian retailers, for a total price of $A2 million.

[54] For simplicity, we will ignore the time-lag between placing an order and delivery, and focus on the time-lag, and thus the inter-company payable arising, between delivery and payment.

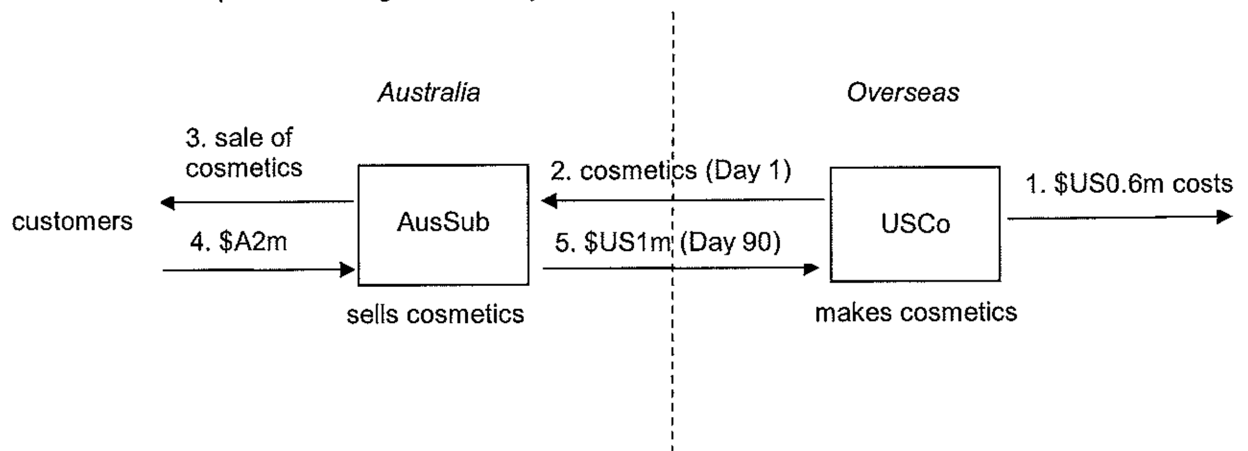
- AusSub does not hedge the trade credit amounts payable to USCo in $US, and simply uses available $A funds to acquire the necessary $US on each payment date.

- Relevant exchange rates/values are as follows:

  - at the time when the goods become on hand to AusSub: $A1 = $US0.8000. Accordingly, at that time, $US1 million equates to $A1,250,000; and

  - at the time, 90 days later, that the $US1 million is paid by AusSub to USCo: $A1= $US.6667 [55]. Accordingly, at that time, $US1 million equates to $A1,500,000. That is, AusSub uses $A1.5 million to acquire the $US1 million it is required to pay USCo.

The facts can be represented diagrammatically as follows:



The Features are as follows:

- **Time frame**: assume all the relevant facts occur within the same tax year for each of AusSub and USCo.

- **Dealing**: in this example, we are concerned with an actual Transaction and not a Dealing.

- **Currency**: AusSub has amounts denominated in both $A and $US.

- **Tracing**: in practice, for high volume cosmetics, AusSub would not track/trace costs to specific amounts of sales income, but would account on an aggregate basis, using a rule of thumb, such as first in first out ("**FIFO**").

- **Trading profile**: As a result of the above transactions, AusSub makes a gross profit (before selling/administration expenses etc) of $A0.5 million, being the difference between the $A2 million sales proceeds and the $A1.5 million used to acquire the $US1 million paid to USCo. (USCo has a gross profit of $US0.4 million, being the difference between the $US1 million sales proceeds from AusSub and its manufacturing cost of $US0.6 million.)

Tax implications

The Australian taxation treatment of the above facts for AusSub should be as follows:

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[55] Given the regular volatility of foreign exchange rates, the assumed movement in the $A/$US rate in this example, over a 90 day period, is not particularly remarkable: swings of this magnitude, over this time frame, occur relatively frequently. Although admittedly a fairly extreme period of volatility, the $A moved from $US0.9774 to $US0.6120 during a 103 day period (17 July 2008 to 28 October 2008), i.e. in the course of the recent global financial crisis: rates taken from www.oanda.com.

- assessable sales income of $A2 million: s.6-5;
- an allowable deduction for the cost of trading stock of $A1,250,000: s.8-1 and s.70-15; and as regards the translation of the $US1 million payable when the trading stock becomes on hand: item 8 in the table in s.960-50(6); and
- an allowable deduction for a Div.775 forex realisation loss of $A250,000 upon payment of the $US1 million trade creditor to USCo: s.775-30.[56]

In other words, AusSub will have net assessable income of $A0.5 million, which equates with its gross/cash profit.

Some observations on these tax outcomes are as follows:

- Because it has been assumed that AusSub and USCo are acting at arm's length, there is no room, in this Example, for operation of the transfer pricing rules in s.136AD (Div.13) and in Article 9 (Associated Enterprises) of the Australia/United States DTA.
- Due currently to the operation of Div.775, and previously under case-law, two distinct taxable events occur for AusSub as regards the transaction with USCo: (a) a deduction for the cost of acquiring trading stock, and (b) settlement of the trade creditor/amount payable, which gives rises to a foreign exchange loss.
- The fact that USCo "sees" no foreign exchange gain (given that it has a $US functional currency, and all transactions from its perspective are $US denominated) does not prevent a foreign exchange loss arising for AusSub.
- There would generally be no suggestion that the payment of the gross $US1 million trade creditor/amount payable, by AusSub to USCo in the ordinary course of AusSub's business, would be any form of "repatriation of capital" by AusSub. A "repatriation of capital" would generally only be thought to occur to the extent that AusSub paid a dividend out of net profits ascertained after deducting selling/administration expenses etc from the gross profit of $A0.5 million (or by AusSub returning any surplus share capital subscribed by USCo.)
- USCo's manufacturing cost (i.e. $US0.6 million), as regards the good sold to AusSub, is irrelevant to the calculation of AusSub's Australian taxable income. If the amount paid by AusSub for the stock (i.e. $US1 million) exceeded an arm's length price, it could be reduced to an arm's length value under s.136AD(3), however this should still generally leave some profit to USCo, as the reward to it for the manufacturing function.

Example 3: inbound trading stock (intra-entity facts)

Facts and Features

The following Example is based on the inter-company Example 2 considered above, but amended so as to involve a head/office branch structure, rather than a parent/subsidiary arrangement.

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[56] Payment of the $US1 million by AusSub to USCo will give rise to forex realisation event 4: s.775-55(1). A forex realisation loss will arise under s.775-55(5), and be deductible under s.775-30(1), as the amount paid by AusSub in respect of the event happening, being $A1.5 million (i.e. $US1 million translated when paid, per item 11 in the table in s.960-50(6)), exceeds the proceeds of assuming the obligation, being the $A1.25 million value of the trading stock when the items become on hand, per the definition of "Proceeds of assuming an obligation to pay foreign currency" in s.775-95, and item 2 in the table of "tax recognition time" items in s.775-55(7). (Although a sensible (but complex!) result arises in this case, the forex rules in Div.775 do not seemingly always work well for foreign currency denominated trading stock transactions: see *Trading stock lost in a forex maze*, Tony Frost, The Tax Specialist, Vol 7/4, April 2004.)

The facts are as follows:

- A US based multinational ("**USCo**"), involved in the manufacture and sale of women's cosmetics, has an Australian PE that undertakes wholesale selling operations ("**Branch**"). That is, Branch imports/distributes products to Australian retailers that have been manufactured by the head office of USCo ("**HO**"), or other members of the group.

- USCo undertakes, records and prices intra-entity Dealings on an arm's length basis, in a similar/analogous fashion to Transactions undertaken with third parties and its own subsidiaries.

- Branch obtains a shipment[57] of cosmetics from HO and is required to "pay" the $US1 million (arm's length) purchase price 90 days after delivery. USCo sells all of its products to related and unrelated parties in $US and allows all such purchasers a 90 day payment period. The manufacturing cost to HO of the products transferred to Branch is $US0.6 million.

- Branch sells the cosmetics imported from HO, to Australian retailers, for a total price of $A2 million.

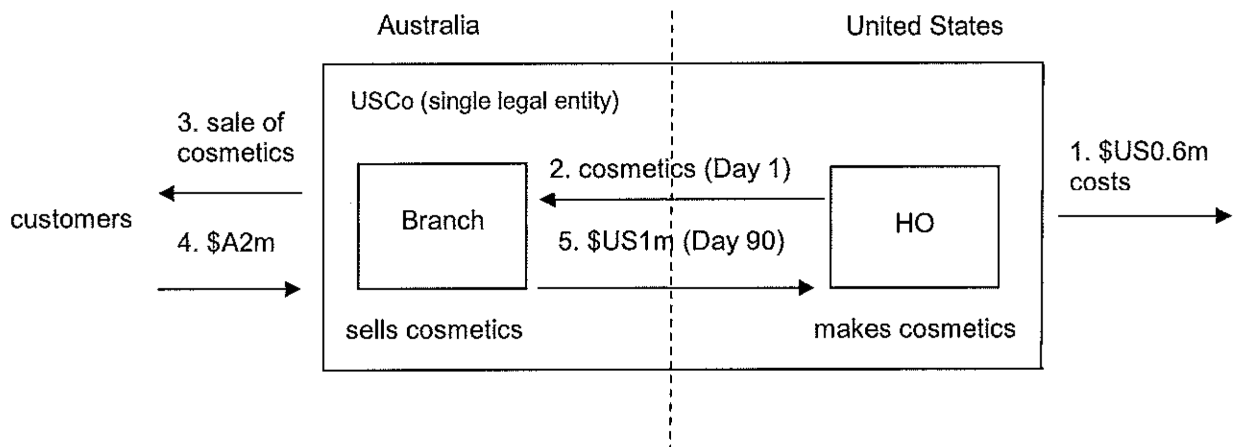
- Branch does not hedge the trade credit amounts payable to HO in $US, and simply uses available $A funds to acquire the necessary $US on each payment date.

- Relevant exchange rates/values are as follows:

  - at the time when the goods become on hand to Branch: $A1 = $US0.8000. Accordingly, at that time, $US1 million equates to $A1,250,000; and

  - at the time, 90 days later, that the $US1 million is paid by Branch to HO: $A1= $US.6667. Accordingly, at that time, $US1 million equates to $A1,500,000. That is, Branch uses $A1.5 million to acquire the $US1 million it is required to pay HO.

The facts can be represented diagrammatically as follows:



The Features are as follows:

- **Time frame**: assume all the relevant facts occur within the same tax year for each of Branch and HO.

57 For simplicity, we will again ignore the time-lag between placing an order and delivery, and focus on the time-lag, and thus the inter-company payable arising, between delivery and payment.

- **Dealing**: in this example, unlike Example 1, USCo recognises a Dealing and seeks to price it on an arm's length basis.
- **Currency**: Branch has amounts denominated in both $A and $US.
- **Tracing**: in practice, for high volume cosmetics, Branch would not track/trace costs to specific amounts of sales income, but would account on an aggregate basis, using a rule of thumb, such as first in first out ("**FIFO**").
- **Trading profile**: As a result of the above transactions, USCo on an overall basis has a gross profit of $US0.4 million arising from its HO operations as well as $A0.5 million from its Australian Branch operations. (HO has a gross profit of $US0.4 million, being the difference between the $US1 million received from Branch and its manufacturing cost of $US0.6 million. Branch has a gross profit (before selling/administration expenses etc) of $A0.5 million, being the difference between the $A2 million sales proceeds and the $A1.5 million used to acquire the $US1 million paid to HO.)

Tax implications

At the risk of stating the obvious, the Australian taxation treatment of the above facts for Branch is not as straight forward as that arising for AusSub in Example 2.

The facts in Example 2 are loosely based on *Max Factor*.[58] It is worth noting briefly what was in issue and what was decided in that case. The taxpayer in *Max Factor* sought to deduct exchange losses upon the transfer of $US funds from its Australian branch to its US head office. The exchange losses were claimed as a deduction on the basis that the transfers of funds were themselves payments by its Australian branch to its head office for raw materials and packaging materials imported by it from the United States to be used by it in the manufacture in Australia of cosmetics.

David Hunt J in the Supreme Court of NSW dismissed the taxpayer's appeal from the Board of Review decision in Case N105, 81 ATC 577, with the Court summarising the Board's findings as being:

> *"(a) that the taxpayer's head office in the United States and its branch in Australia formed a single entity;*
> *(b) that the exchange losses claimed as a deduction were **not incurred in the discharge of a liability incurred on revenue account, but that they related rather to a repatriation of the taxpayer's capital by the branch in Australia to its head office** in the United States (and **thus were not allowable deductions** as losses or outgoings under sec. 51(1)); and*
> *(c) that the losses of the working or circulating capital of the taxpayer, which those losses represented, were in fact incurred by the taxpayer's head office in the United States and not by its branch in Australia (and thus were not allowable deductions under para. (3) or (4) of Art. III of the United States Convention, which is incorporated with and must be read with the Income Tax Assessment Act: Income Tax (International Agreements) Act 1953, sec. 4(2)."* (emphasis added)

The Court stated at 84 ATC 4060:

> *"As to sec. 51(1), I agree with the view of the Board of Review that the taxpayer must fail, upon the basis that the **transfers of funds** from the taxpayer's branch in Australia to its head office in the United States amounted to **no more than purely internal transactions; there was, in my view, no payment by the Australian Branch in discharge of a liability incurred by it** to the taxpayer's head office in the United States. The payment was no more than a reimbursement by the Australian*

[58] In *Max Factor*, the Australian branch of the US company imported raw materials and packaging materials so as to manufacture cosmetics, which it then on-sold.

> *branch to the head office in the United States for a payment made by it to the supplier in that country.*" (emphasis added)

The Court also rejected the taxpayer's argument in relation to the applicability of the Australia/US DTA.[59]

It is important to note that what was in dispute was the deductibility of the relevant *FX* losses. That is, the ATO appears to have accepted that some amount was properly deductible in relation to the cost of goods manufactured/sold in Australia. This point does not come through clearly in the Court decision, however it can be seen in the reasons of Acting Chairman J.R. Harrowell in the Board's decision, at 81 ATC 585:

> "*Under sec. 51 of the Act* ***the branch is allowed to claim the cost of the trading stock*** *imported and under para. (4) of Art. III of the Convention that* ***cost must be determined on an arm's length basis.*** *In my opinion the cost of the imported trading stock was the cost incurred by the entity, viz. the head office in the United States. Under sec. 20 of the Act that cost must be expressed in Australian currency. As neither the costs on the head office "invoices" nor the standard exchange rate adopted when charging those costs to inventory were disputed I adopt them.*" (emphasis added)

As regards this "cost", the Acting Chairman of the Board noted at 81 ATC 580:

> "*With regard to stock head office applied a mark up of some 5% to 10% to cover the cost of carrying the stock and handling and packing charges.*"

In other words, and quite consistent with s.136AE(4) (not then enacted) and our DTAs, the branch was entitled to a deduction on an arm's length basis as regards the relevant stock. The difficulty arose from the delay in "payment" to the head office and the resulting FX "loss".

One key aspect of both the Board and Court decisions which, with respect, is difficult to accept is the notion that seemingly the *entire* transfer of funds from the Australian branch to its head office was a "repatriation of capital"; with this finding adding to the non-deductibility of the amounts in question. It can be accepted that where a branch remits an amount to its head office that is referable *either* to the capital originally invested in the branch, *or* to *profits* made by the branch (in either case having due regard to the entity's accounts), then this can be seen as a "repatriation of capital". However, as in the case of the inter-company facts in Example 2, it does not seem appropriate to describe a transfer of funds referable to/reimbursing the (gross) cost element of a trading stock transfer as being a "repatriation of capital" – at least not in situations where the entity has made an overall profit from the relevant transactions.

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[59] Max Factor, 84 ATC 4060 at 4063: "*The taxpayer's argument is that para. (4) [of the Australia/US DTA] treats payments made by its Australian branch to its head office in the United States as if they were made by an independent enterprise in Australia dealing at arm's length with another enterprise in the United States. The payments which were made should, it is argued, be deemed therefore to be payments which were made in discharge of a liability incurred by the Australian branch to its head office in the United States. The Commissioner, on the other hand, says that para. (4) does not translate a transfer of funds from the taxpayer's Australian branch to its head office in the United States in order to cover an expense incurred by that head office in the United States into an expense incurred here by the Australian branch. It does not permit the head office to claim a tax deduction for that expense in the United States and the Australian branch to claim a second tax deduction in Australia for the same expense. For the deduction to be allowed, the Commissioner says, the expense must be incurred here in Australia (that is, there must be a discharge of a liability incurred here) and the expense must relate to the profits derived by the Australian branch here in Australia. Those profits are the taxable income derived from its activity or business (that is, here in Australia): Income Tax (International Agreements) Act, sec. 3(2). This, the Commissioner says, is made clear by the terms of para. (3), which refers only to expenses of that type. I accept the Commissioner's argument. I am satisfied that, in the present case, the liability in relation to the raw materials and the packaging materials imported by the taxpayer's Australian branch was discharged by payment by the head office in the United States to the supplier in the United States, and not by the transfer of funds by the taxpayer's Australian branch to its head office in the United States to cover that payment. There was thus no expense incurred in Australia in discharge of a liability incurred here which could be deemed by para. (4) of Art. III to affect the profits attributed to the Australian branch. The provisions of the United States Convention do not assist the taxpayer.*"

Returning now to the facts of Example 3 and the implications for Branch.

Branch obtains cosmetics from HO and is required to "pay" the $US1 million (arm's length) purchase price 90 days after delivery, although the manufacturing cost to HO of the products sold to Branch is $US0.6 million.
At the time when the goods become on hand to Branch: $A1 = $US0.8000. Accordingly, at that time, $US1 million equates to $A1,250,000. Seemingly, this is the amount that the ATO would/should (at least) accept is deductible for the purposes of s.8-1, having regard to the principles in s.136AE; the ATO's practical comments in TR 2001/11 (see discussion above in Example 1), and the Board's decision in *Max Factor*. That is, the deduction is not limited to HO's actual *costs* (i.e. $US0.6 million), but to the *arm's length amount* (i.e. $US1 million).

However, what appears to be in contention is the *FX loss* of $250,000 arising from the fact that when Branch actually "pays" the $US1 million to HO 90 days later, by then $A1= $US.6667. Accordingly, at that time, $US1 million equates to $A1,500,000. That is, Branch uses $A1.5 million to acquire the $US1 million it is required to pay HO.

Given the decision in *Max Factor*, it is difficult to see the ATO accepting a deduction for the FX loss of $A250,000 under current law/practice – whether having regard to s.136AE(4), or the current Article 7 of the Australia/US DTA.

The interesting question which then arises is how the FX loss of $A250,000 *should* be treated, at least under an FSE approach, if not under s.136AE(4), or the current Article 7. As can be seen in Example 2 above, it is uncontentious that AusSub (an actual separate entity) would be entitled to a deduction for its corresponding loss of $A250,000. Presumably, the same result should arise for Branch under an analogous FSE approach. That is, the settlement/payment by Branch of the $US1 million to HO should be viewed as a separate (albeit related) taxable event/taxing point to the actual importation of the stock, i.e. analogous to a trade creditor in the case of separate entities. In the circumstances, the "character" of this intra-entity creditor, being referable to trading stock, should be seen to be revenue in nature.[60]

The focus of the above discussion has been on the Currency Feature of the facts. As regards other Features, and variations thereon, comments in Example 1 above are generally also relevant by analogy in this Example 3.

Example 4: outbound intra-bank loan

Facts and Features

The facts of the Example are as follows:

- An Australian resident authorised deposit-taking institution ("**Bank**") has its head office ("**HO**") in Australia and a PE in the United States ("**Branch**"). Branch's income is NANE in Australia pursuant to s.23AH.

- In the ordinary course of its banking business, HO receives $US denominated deposits and makes $US loans to customers in Australia. If HO has surplus $US it may provide these funds to Branch, from time to time, by means of interbranch $US denominated loans[61] – with terms of up to (say) five years.

- All $US deposits received by HO are pooled/co-mingled, such that it is not possible to trace particular deposits as having been used to make one or other interbranch $US loans. All of the interbranch loans received by Branch from HO are pooled/co-mingled (including with $US funds raised by Branch without the involvement of HO), such that

[60] More difficult issues arise where branch capital is involved: see Appendix 2 to this paper.

[61] Assume that the funds thus provided are not regarded as an attribution of ADI equity capital to an overseas PE of Bank for the purposes of s.820-300(3)(a) in the outward investing ADI thin capitalisation rules. See also TR 2005/11, and in particular paragraph 48.

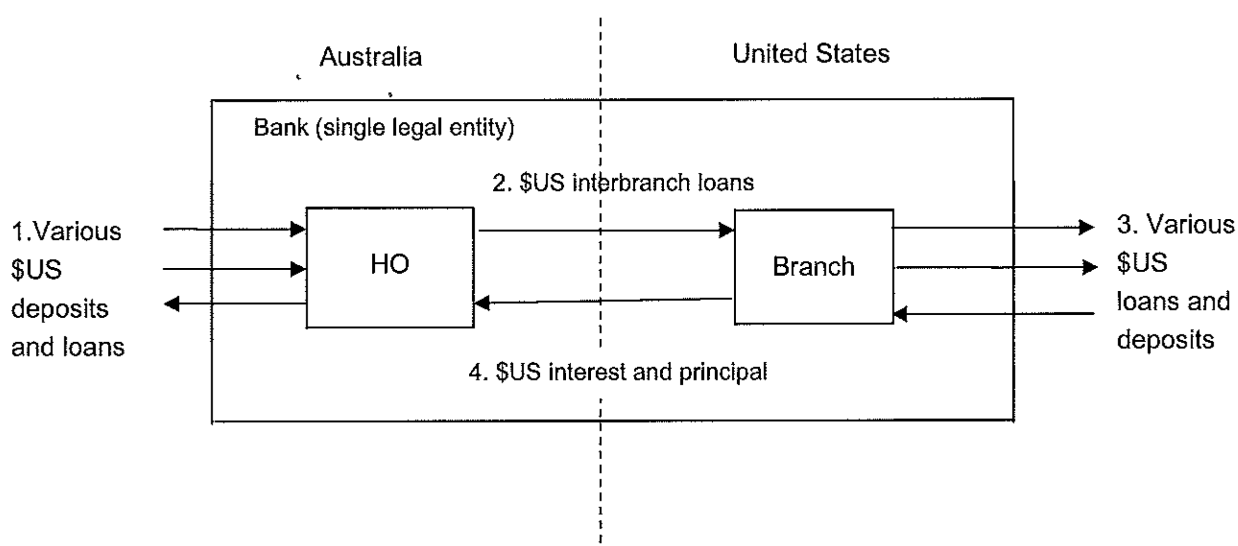
it is not possible to trace particular interbranch loans as having been used to make one or other $US loans to Branch's customers.

- HO and Branch each recognise, account for, and price, on arm's length terms (e.g. by reference to the relevant $US LIBOR/interbank rate), a Dealing as regards each interbranch $US loan.

- Branch "pays" principal and interest to HO on each interbranch $US loan, in the same way as it would with a third party Transaction on similar terms.

- Assume, for the purposes of the Example, that the following average interest rates apply over a relevant period of time:
  - $US interest paid by HO to depositors in Australia: 5% p.a.
  - $US interest paid by Branch to HO on interbranch loans: 6% p.a.
  - $US interest received by Branch on loans to its customers: 7% p.a.

The facts of this Example can be represented diagrammatically as follows:



The Features of this Example are as follows:

- **Time frame**: some of the interbranch loans will span a number of tax years for each of HO and Branch.

- **Dealing**: each of HO and Branch recognise a Dealing and seek to price it on an arm's length basis.[62]

- **Currency**: relevant third party deposits and loans, and the interbranch loans, are all denominated in $US.

- **Tracing**: due to the pooling/co-mingling, it is not possible to track/trace specific $US deposits of HO to one or other interbranch loans made to Branch.

- **Trading profile**: having regard to the average interest rates noted above, Bank makes an overall (positive) net interest margin/spread of 2% from the third party transactions in question, which it attributes to each of HO (1%) and Branch (1%) by means of the pricing on the interbranch loans.

Tax implications

1. General comments/background: TR 2005/11

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[62] See paragraphs 26 to 30 of TR 2005/11.

In considering the Australian taxation treatment of the above facts for Bank, it is useful to have regard to some of the discussion and examples in Taxation Ruling TR 2005/11: *Income tax: branch funding for multinational banks*. Paragraph 1 of TR 2005/11 provides that it "*specifically focuses on such issues arising where a bank internally transfers funds to or from a PE in the ordinary course of carrying on business through that PE. Such a transfer of funds is referred to in this Ruling as an interbranch funds transfer.*"[63]
The "Ruling" part of TR 2005/11 provides as follows:

> "*9. We accept entries in a bank's books of account that reflect arm's length interest charges on interbranch funds transfers as a means of determining an allocation or attribution of the bank's income, expense or profit in accordance with Australia's PE attribution rules.*"

In paragraph 16, the ATO states that an interbranch payment or charge is not itself recognised as assessable income or a deductible expense. Rather, actual income and expenses that the entity earns from or pays to third parties are allocated or attributed between branches. The arm's length separate enterprise principle permits intra-entity dealings to be recognised and priced by analogy to arm's length separate enterprise transactions, for the purpose of allocating or attributing the entity's third party income and expenses.

In relation to pooling/co-mingling, TR 2005/11 provides:

> "*18. The nature of the business of a bank means that it is* ***not ordinarily practicable or possible to trace either the source or end use of funds transferred between branches*** *such that the entity's actual third party income or expense associated with those funds can be allocated or attributed between branches.* ***The practical problems this creates are analogous to those discussed at paragraphs 5.5 to 5.16 of TR 2001/11 in respect of trading stock*** *transferred between parts of an enterprise whose business is product manufacture and sale.* ***The solution proposed at paragraph 5.16 of TR 2001/11 may be equally appropriate for banks. Accordingly, our practice is to accept the allocation of income and expenses on the basis of the transfers in a bank's accounts prepared on a separate entity basis rather than allocating the actual third party income and expense.*** *This is on the proviso that the accounts have been properly prepared and the allocation or attribution outcomes are the best estimate of branch profits that can be made in the circumstances.*
>
> *19. For a bank that is in the business of borrowing and lending money, the above approach accords with the reasonable presumption that the vast bulk of funds transferred interbranch has been borrowed at some stage from third parties and will be lent eventually to third parties. In this context, regard may be had to payments or charges of interest on interbranch loans as reflecting actual outgoings and receipts of the financial enterprise as a whole. In other words, amounts equivalent to interbranch interest paid and received can be recognised to give a result consistent with an allocation or attribution of actual third party income and expenses or profit as required by Australia's PE attribution rules.*" (emphasis added)

TR 2005/11 contains a number of examples, one of which, *Interbranch funds transfer - Australian head office to offshore PE*, is similar to our Example 4 although it appears implicit from TR 2005/11 that the example interbranch loan therein is $A denominated. TR 2005/11 provides the following discussion on this example:

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[63] Paragraph 4 provides that TR 2005/11 applies to Australian banks with foreign PEs and to foreign banks with Australian PEs. Paragraph 7 states: "*The OECD is currently developing guidance on the attribution of profits to PEs for the purposes of Article 7 of the OECD Model Tax Convention. This will include a specific discussion on profit attribution for bank branches. Once this guidance is finalised and implemented by the OECD, issues will arise regarding Australia's adoption of the OECD views, particularly to the extent that they may not accord with current Australian law. For instance, the OECD's proposed 'functionally separate enterprise approach' is not the same as Australia's current approach of allocating actual income and deductions. While future developments in this regard must be awaited, we would expect that in relation to bank interbranch lending the OECD's proposed views should in practice produce similar profit attribution outcomes to our views as stated in this Ruling.*"

"46. Where funds are loaned by a bank's Australian head office to a foreign branch and used by the branch to derive income, the recognition of an interbranch interest charge effects an allocation to the head office of some part of that income. The income thereby allocated to the head office is not income of the foreign branch for the purposes of section 23AH of the ITAA 1936 and is assessable income of the head office. The interest expense incurred by the entity through the head office, related to those funds is not attributable to the foreign branch, and a deduction for this expense is not denied by subsection 8-1(2) of the ITAA 1997. Division 820 of the ITAA 1997 covers this interest expense. Australia's PE attribution rules apply to the amount attributed to ensure that the pricing of the interbranch loan is not less than arm's length."

2. Interbranch issues not addressed in TR 2005/11: timing of interest income/expense and whether to recognise FX gains/losses

There are at least two key tax issues as regards interbranch loans that are not addressed in TR 2005/11. The first issue is the *tax timing* treatment of intra-bank *interest*, i.e. precisely *when* should amounts be attributed as being income/expense (i.e. regarded as being effectively derived/incurred) of head office? It appears clear that, in practice, Australian banks for many years have applied a similar tax accounting treatment to interbranch loans as they do to third party loans. As a result, (pre Div.230 discussed below) a "daily accruals" basis of interest income recognition would apply to interbranch loans, on an analogous basis to that applying to equivalent Transactions under Taxation Ruling TR 93/27.

The second issue not addressed in TR 2005/11 is the treatment (pre Div.230) of FX gains/losses on foreign currency denominated interbranch loans. That is, when a branch "repays" a $US denominated interbranch loan to head office, head office (typically with an $A tax functional currency for Australian tax purposes) will "experience" an FX gain/loss, due to currency exchange rate fluctuations, even if the foreign branch (i.e. for local tax purposes) does not likewise "experience" an offsetting FX loss/gain, given that the interbranch loan was denominated in its local currency.

Once again, in practice, it appears that Australian banks typically have applied a similar treatment to FX gains/losses on interbranch loans as they do to third party foreign currency denominated loans. In other words, (and pre Div.230) realised FX gains/losses upon repayment of arm's length interbranch loans would be regarded as giving rise to (attributable) assessable income/allowable deductions in Australia. This would be seen as a reasonable/natural extension of the principles in paragraphs 9, 18 and 19 of TR 2005/11.

Head office would typically only make a foreign currency denominated interbranch loan (asset), or receive a foreign currency denominated interbranch borrowing (liability), if the FX risk thus created is offset by foreign currency risks otherwise arising in its Australian business. (Banks generally have strict limits to negate or minimise "open" (unhedged/unmatched) FX positions.) As a result, FX gains/losses on interbranch loans would have a nexus to Australian assessable income/business in a similar way to analogous third party Transactions.

Consider first a *Transaction* where a bank parent borrows $US100 from a third party and makes a loan of $US100 (on arm's length terms) to a US *subsidiary*, which in turn lends $US100 to a customer. As a result, the bank group (and the bank parent itself), on an aggregate/global basis, is fully hedged and will not make any net FX gain or loss. In this case, it would be clear that FX gains and losses on each of the borrowing and loan asset from the perspective of the bank parent would be assessable/deductible (and thus offset each other) for Australian tax purposes.[64]

[64] Depending on the facts and when the transactions occurred, gains/losses may be recognised under the general assessing provisions; the former Div.3B of Part III, or Div.230.

The same result in principle should arise in the case of a *Dealing*, i.e. where a bank head office borrows $US100 from a third party and makes a loan of $100 to a US branch rather than a subsidiary, with the branch then lending $US100 to a customer. The branch (like the subsidiary in the Transaction above) will not "see"/experience any FX gains/losses for US tax purposes, given that everything happens in $US, being the home currency for US tax purposes. Accordingly, any FX gains/losses will only arise from an Australian ($A functional currency) perspective. Any FX gain made by the bank head office on the $US100 third party borrowing would be assessable in Australia and should be offset by a deduction for an equal FX loss on the interbranch loan.

From an Australian tax perspective, there would appear to be three common alternative scenarios for the Australian tax treatment of a foreign branch which borrows and on-lends amounts denominated in the local currency of the branch – each of which will (appropriately) produce no net impact from an Australian tax perspective (thus assisting in confirming that the bank head office should be entitled to a deduction for a loss on an interbranch loan, so as to mirror/offset the FX gain on the third party borrowing):

- all activities of the branch are NANE under s.23AH, such that no amounts are recognised in Australia;
- the activities of the branch are not subject to s.23AH, but a functional currency election under Subdiv.960-D applies, with the local currency of the branch being the functional currency, such that no FX gains/losses are recognised; or
- the activities of the branch are not subject to s.23AH, and no functional currency election applies, such that equal/offsetting FX gains/losses in $A terms are recognised by the branch on its third party loan asset and its side of the interbranch loan with head office.

Further, at least in facts of this type (i.e. "revenue account" interbranch loan of a bank), the decision in *Max Factor* as to the non-recognition of internal FX losses should be regarded as distinguishable; banks long being acknowledged as generally "different" as regards PE attribution issues.[65] (The principle/decision in *Max Factor* should have application to certain other fact patterns of banks.)

In summary, although it should be possible to conclude that FX gains/losses on arm's length Dealings within a bank analogous to loans should be recognised under Australia's existing PE attribution rules, the position would be far simpler/clearer if a legislative reform to mandate a "functionally separate enterprise" approach was undertaken.

3. Treatment of interbranch interest income/expense and FX gains/losses using Div.230 methodologies

We return now to the facts of Example 4 and the tax implications for Bank, and in particular HO. We will assume that the facts occur after the commencement of the TOFA rules in Div.230. Also assume that Bank has made all of the relevant tax timing elections in Div.230, i.e. the reliance on financial reports method (Subdiv.230-F); the fair value method (Subdiv.230-C); the foreign exchange retranslation method (Subdiv.230-D); and the hedging financial arrangements method (Subdiv.230-E).[66]

Consistent with its pre-Div.230 practice, Bank would recognise the $US interest income on the interbranch loans. Using the average interest rates noted above, and consistent with paragraph 46 of TR 2005/11, HO of the Bank would recognise/attribute interest income at the rate of 6% p.a. on the interbranch loans made to Branch, against which it would deduct interest paid at an average rate of 5% p.a., leaving an assessable net interest margin in

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65 For example, see "The Taxation of Multinational Banking Enterprises", in Transfer Pricing and Multinational Enterprises – Three Taxation Issues, OECD, Paris, 1984; the OECD Report generally and Part II in particular; and paragraph 6 of TR 2001/11.

66 Section 230-40 provides a hierarchy within these elective methods and the default methods (accruals and realisation).

Australia of 1%. For Australian tax purposes, Branch would have income of 1% p.a. (being actual/third party income of 7% p.a., less the 6% p.a. attributed to Australia), which would be NANE pursuant to s.23AH. In other words, the correct approach under s.136AE(4) and relevant DTAs (as per paragraph 46 of TR 2005/11), is to attribute income to Australia (against which Australian funding costs are deductible), and not to disallow Australian funding costs as incurred in deriving s.23AH NANE income. (If the later approach was adopted, the Australian Revenue would be worse off, as the 1% net margin would not be returned as assessable in Australia.)

The question arises as to exactly when/how HO will recognise interest income at the rate of 6% p.a. on the interbranch loans made to Branch. Although the interbranch loan is clearly not a "financial arrangement" (as it is not a legally recognised transaction/arrangement of any type) HO would want (for practical, compliance, and common sense reasons) to apply the same timing rules as it would for third party Transactions. Accordingly, where HO has made the financial reports election under Div.230 that applies to its actual financial arrangements, HO would seek to apply the same timing methodology, *by analogy*, to interbranch loans. Strictly speaking, Div.230 cannot "apply" to an interbranch loan, as it is not a financial arrangement. Rather, Div.230 merely provides a (sensible) framework as to when/how amounts will be attributed under the relevant PE attribution rules. The use of Div.230 methods in this respect, especially where the bank has made the financial reports election is completely consistent with the approach adopted by the ATO in paragraph 9 of TR 2005/11, noted above, where accounting records (which is what are required in the financial reports method in Div.230) are not only acceptable but are in fact mandated, i.e.:

> "*We* ***accept entries in a bank's books of account*** *that reflect arm's length interest charges on interbranch funds transfers as a means of determining an allocation or attribution of the bank's income, expense or profit in accordance with Australia's PE attribution rules.*" (emphasis added)

The next question is exactly when/how HO will recognise FX gains/losses on the interbranch loans made to Branch (assuming, as discussed above, that *prima facie* such FX gains/losses should in fact be recognised). As noted above, the pre-Div.230 approach would typically have been realisation. In a Div.230 world, HO will typically recognise FX gains/losses on third party Transactions on unrealised/retranslation basis – generally via the financial reports method. Once again, recognition of FX gains/losses on an interbranch loan on the same (unrealised/retranslation) basis, that will also be adopted by HO for its internal accounting as regards the interbranch loan, is consistent with the approach in TR 2005/11. Where an interbranch loan spans a number of tax years, the sum of the unrealised/retranslation FX gains/losses over the life of the loan will equal a FX gain/loss calculated only on a realisation basis. Accordingly, the "correct" amount of FX gain/loss will remain the same.

Without use of an unrealised/retranslation FX basis for interbranch loans, timing mismatches/distortions will arise in HO's tax accounting, as between third party $US borrowing/loan assets and interbranch $US borrowing/loan assets. Under pre Div.230 law/practice, typically no such timing mismatches/distortions will arise as realisation would be used for both Transactions and Dealings.

Example 5: cross-border intra-bank currency swaps

Facts and Features

The facts of the Example are as follows:

- As with Example 4, an Australian resident authorised deposit-taking institution ("**Bank**") has its head office ("**HO**") in Australia and a PE in the United States ("**Branch**"). Branch's income is NANE in Australia pursuant to s.23AH.

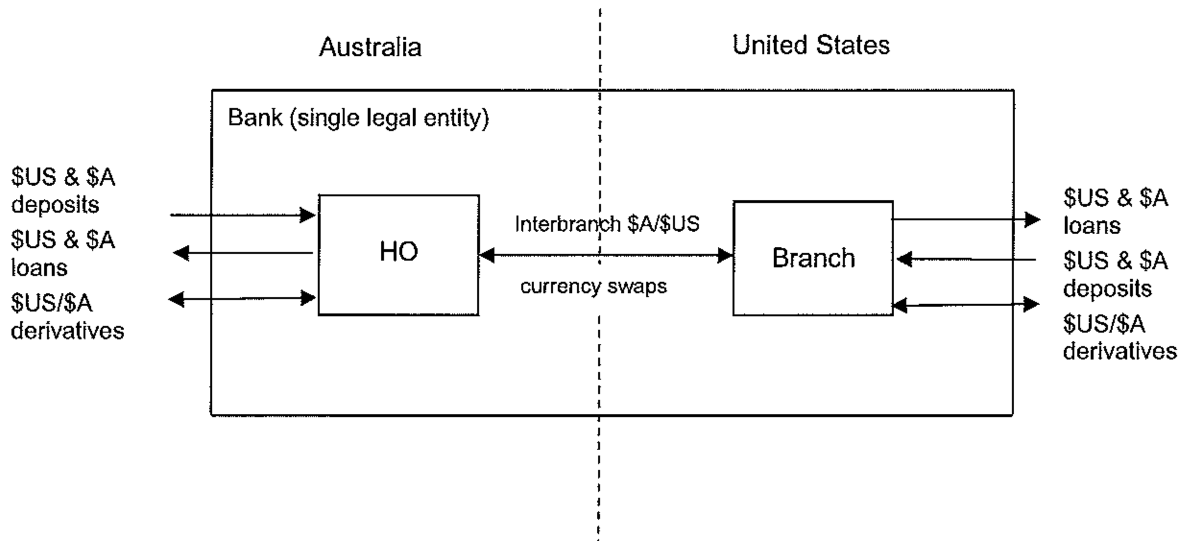
- In the ordinary course of banking business, each of HO and Branch have the following Transactions with third parties:
    - $A and $US denominated deposits from customers;

- $A and $US loans to customers; and
  - $A/$US derivatives (e.g. currency swaps, forward FX contracts etc) with customers.

- As a result of their various activities, HO may have a net exposure to $US, and/or Branch may have a net exposure to $A. Rather than hedge/lay-off that risk with a third party, HO and Branch may enter into arm's length Dealings analogous to derivative Transactions undertaken with third parties (e.g. currency swaps, forward FX contracts etc; but assume for the purposes of this Example that the Dealings are analogous to currency swaps); with the internal position thus created itself then managed/hedged etc on a whole-of-book basis by each of HO and Branch.

- HO and Branch each recognise, account for, and price, on arm's length terms a Dealing as regards the interbranch currency swap, with the three aspects of the Dealing (similar to a Transaction with a third party) being as follows:
  - initial exchange of $A and $US principal amounts;
  - periodic payments and receipts calculated as a % of the $A and $US principal amounts; and
  - a re-exchange of $A and $US principal amounts on maturity.

The facts of this Example can be represented diagrammatically as follows:



The Features of this Example are as follows:

- **Time frame**: interbranch swaps will often span a number of tax years for each of HO and Branch.

- **Dealing**: each of HO and Branch recognise a Dealing and seek to price it on an arm's length basis.[67]

- **Currency**: HO will have $A and $US denominated rights/obligations under the interbranch swaps.

- **Tracing**: due to the "book" (aggregate) nature of the FX risks run/managed by each of HO and Branch, it is not possible to track/trace specific interbranch swaps to one/more actual third party Transactions.

- **Trading profile**: assume that each of HO and Branch make net overall (positive) net taxable income from an aggregation of the various Transactions and Dealings.

[67] See paragraphs 26 to 30 of TR 2005/11.

Tax implications

The Australian taxation treatment of the above facts in a Div.230 environment is as follows:

Firstly, it should be noted that in the case of currency swaps that are actual Transactions, including those undertaken by a bank with a foreign subsidiary, typically fair value (i.e. what used to be called marked-to-market) tax treatment will apply under the rules in Div.230[68], e.g. where a bank makes a financial reports election, given that derivatives, such as currency swaps, will generally be fair valued for financial accounting purposes under Accounting Standard AASB 139. The only exception to this treatment is if a currency swap or other derivative is used as a hedge and hedge accounting applies under AASB 139, with the tax-hedge rules in Subdiv.230-E applying for tax purposes.

As with the interbranch loans discussed in Example 4 above, there are essentially two issues to be addressed as regards interbranch currency swap Dealings:

- *whether* to effectively recognise such Dealings at all for PE attribution purposes; and if so
- exactly *when/how* to so recognise the Dealing, i.e. timing issues.

As regards the "whether to recognise" issue, it is acknowledged that unlike the case of interbranch loans in Example 4 (where TR 2005/11 provides at least some guidance), there appears to be no public guidance from the ATO. Nonetheless, in practice, it appears that interbranch currency swap Dealings have existed for some decades and the ATO has not generally sought to challenge the use of such Dealings, at least those undertaken on arm's length terms, for PE attribution purposes. The logic and rationale for recognising such Dealings is essentially a variant/extension of the approach adopted in TR 2005/11 and the more general guidance in TR 2001/11. The best case for such recognition is to observe the distortions in HO and Branch taxable incomes if such Dealings are ignored.

In relation to the timing aspects of an interbranch currency swap Dealing, HO would generally wish to use Div.230 timing methods (e.g. financial reports method) so as to achieve book/tax consistency in relation to the Dealing, and consistency of tax treatment between interbranch currency swap Dealings and currency swap Transactions. The logic and rationale in this respect largely follows that for interbranch loans discussed in Example 4.

As with the interbranch loans in Example 4, it should be possible to recognise arm's length currency swap Dealings under existing PE attribution rules (using Div.230 timing rules), however it would be far preferable to have clear, specific legislative reform, of the type envisaged by the Ralph Report in 1999.

* * * * *

[68] Prior to Div.230 the Australian tax treatment of currency swaps was unclear. Typically, taxpayers sought to apply the rules in Taxation Ruling IT 2682 (strictly only applicable to bona-fide interest rate swaps) by analogy – at least as regards the periodic payments/receipts under such a swap. Under Div.230, a mix of accruals and realisation rules will apply to currency swaps where financial reports, fair value and hedging elections are not applicable.

APPENDIX 2

Capitalisation of a foreign branch and repatriation of branch capital – a Note on some tax issues arising from fluctuations in foreign exchange rates

Preamble

This Note has been primarily inspired by the facts/decision in *Deutsche Shell GmbH v. Finanzamut* (2008 ECJ Case C-293/06; "***Deutsche Shell***")[69] and discussions held/materials prepared by the Panel (of which the author was a member) for Subject 2 at the International Fiscal Association's 2009 (Vancouver) Congress: *Foreign Exchange Issues in International Taxation*, during which this case, and other tax issues to do with foreign exchange, were considered.

This Note is intended to be exploratory/high-level and not comprehensive in nature.

Introduction

The purpose of this Note is to explore tax issues arising from the "capitalisation" by an entity of a PE/branch, located in a foreign country, and the eventual "repatriation" or return of that capital (in whole, in part, or in an amount in excess of the capital originally contributed.) The terms "PE" and "branch" are used interchangeably in this Note – with each referring to a taxable presence in a country that would constitute a permanent establishment as defined in Article 5 of the OECD Tax Model Convention.

The central theme of this Note is that, generally speaking, tax system design in most countries seems, to date, to have given remarkably little attention to the tax issues arising from the capitalisation of a foreign PE, and the repatriation of that capital. In broad terms, tax system design, in both home/resident and host/source countries, generally focuses on the tax treatment of the *income/losses* arising from the PE, rather than the consequences of the establishment of a PE and the eventual return of the capital invested therein. The relevant tax issues are exacerbated by inevitable movements in the rate of exchange between the currencies of the home/resident and host/source countries.

The approach taken in this Note is non-country specific. A key objective of the Note is to identify issues that it is considered should be taken into account from a policy perspective in designing any country's approach to the taxation of foreign PEs of resident entities.

This Note is also non-industry specific, as the key issues appear similar regardless of the industry sector in which a particular multinational operates. That is, it seems likely that as regards capital injection/repatriation and resulting foreign exchange tax issues, the position for banks should be the same as for other multinationals, notwithstanding that banks are (appropriately) treated differently for what might be called day-to-day Dealings that are analogous to Transactions of a regular/ordinary-course-of-trading nature.

[69] The following summary is based on *German Currency Loss Rules Incompatible With EU Law, ECJ Says*, Tom O'Shea, http://www.law.qmul.ac.uk/people/academic/docs/Deutsche_Shell_WTD.pdf : The European Court of Justice found that German rules concerning the non-deductibility of the depreciation in the value of start-up capital granted by a German company to its permanent establishment in Italy were incompatible with the EC Treaty freedom of establishment principle, due to the fact that the currency loss in question could be deducted in neither Germany nor Italy. In the case, a German resident company, Deutsche Shell, had set up a PE in Italy in 1974 and had injected start-up capital into that establishment. The depreciation in the value of the start-up capital was not taken into account in Italy because the basis of assessment for the taxation of its profits was in Italian lira. The German tax authorities refused to accept that the alleged currency loss was a real financial loss, and Deutsche Shell argued that the denial of the deduction for the currency loss was incompatible with the EC Treaty principle of freedom of establishment because it placed the company "in a less favourable situation than if the 'start-up' capital had been invested in a company established in Germany."

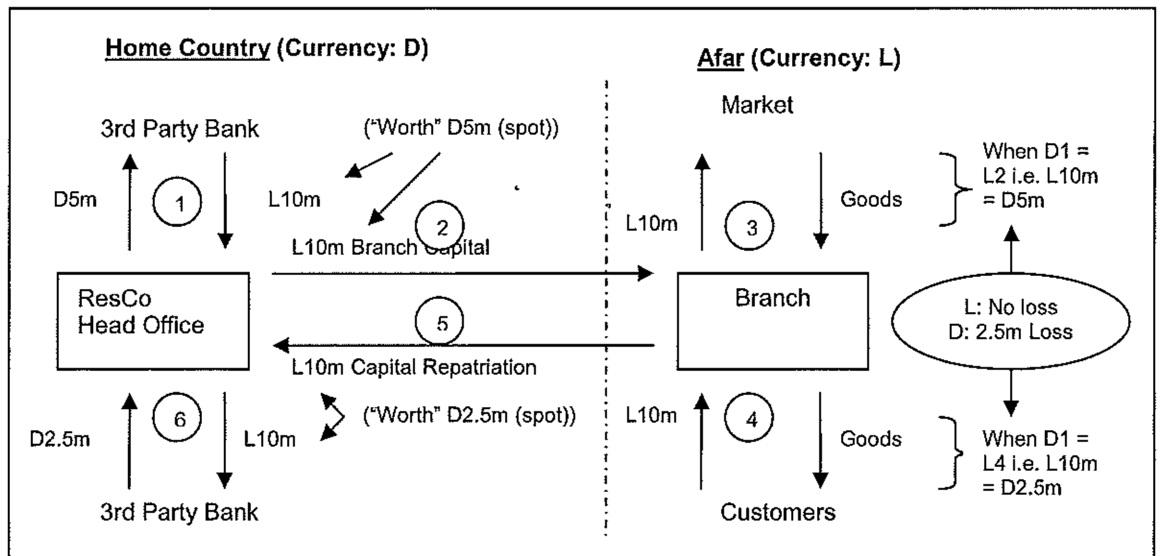
The need for "capital" to be allocated to a PE/branch

There are a number of commercial, regulatory/exchange control and tax related reasons why a multinational entity may wish, or need, to provide/allocate/attribute "capital" to a PE in a foreign country.[70]

Where a multinational group operates in a foreign country via a subsidiary, there will always be some level of capital arising from the issue of ordinary shares or common stock in the subsidiary.

Example

In order to assist with the discussion of the relevant issues, it is useful to posit a highly simplified example of the "life cycle" of a PE/branch, as follows:



Steps, as per Diagram above

1. Spot acquisition of L10m for D5m by ResCo Head Office
2. Afar branch ("**Branch**") established with initial/"dotated" capital of L10m[71]
3. Branch acquires goods for L10m in a spot transaction and stores them
4. Later, Branch sells goods for L10m in a spot transaction when D1 = L4
5. Branch closed and L10m capital repatriated to ResCo Head Office
6. Spot sale of L10m for D2.5m by ResCo Head Office at then rate of D1 = L4

Additional facts/assumptions

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[70] The OECD Report addresses the attribution of "free capital" to PEs at various places; e.g.: in paragraphs 31 to 35; 136 to 141, and 149 to 206 of Part I and at length in Part II in relation to banks. This Note does not seek to review, summarise or comment on the OECD's work in this regard. That is, the Note takes as a given that some capital will be attributed to a PE having regard to the OECD's AOA. The purpose of the Note is to consider some of the consequences (especially foreign currency related issues) of such attribution.

[71] As noted earlier, the objective of this Note is to consider the issues arising from repatriation of branch capital/earnings, especially of an FX nature, and not to consider what is the "correct" attribution of capital to a PE in the first place. For simplicity, the Branch in this example is "thickly" (fully) capitalised. In practice, a PE could be expected to have a mix of capital and debt funding. In addition, and of obvious importance, it is critical to note that ResCo regards itself as having contributed capital to Branch in Branch's/Afar's local currency (i.e. L) and not the currency of ResCo at Home (i.e. D) – consistent with what would seemingly/typically happen in practice, and consistent with the fact pattern where a subsidiary is capitalised with share capital denominated in the currency of the country in which the subsidiary is located. Further consideration of the issues and outcomes would be required in situations where ResCo contributes capital to Branch that is denominated in ResCo's home currency (i.e. D).

- Exchange rates:
  - at Steps 1, 2 and 3: D1 = L2, i.e. L10m = D5m
  - at Steps 4, 5 and 6: D1 = L4, i.e. L10m = D2.5m
- Assume ResCo Head Office has D5m of capital/"free" funds at Step 1
- For simplicity, assume ResCo Head Office does not hedge the L10m capital in Branch[72]
- For simplicity, also ignore storage/holding/admin costs of Branch in Afar.

Economic/cash outcome from all 6 steps/overall "branch life cycle"

- Before Step 1 ResCo has D5m in cash and no "L"
- After Step 6 ResCo has D2.5m in cash and no "L"
- Overall, ResCo has a loss of D2.5m

Taxation issues arising from the Example

- "Should" ResCo be entitled to any tax relief for its economic/cash loss of D2.5m?
- If so, why and how calculated?
- Precisely where/how does the loss arise?
- In which country should relief be allowed, and as foreign or domestic?

Controlled foreign corporation (CFC) analogue

Before considering the Branch fact pattern as posited, it is worth asking what tax outcome might arise if Branch was in fact a 100% owned subsidiary/CFC of ResCo, and the Branch capital was in fact share capital.

That is, ResCo would acquire shares for L10m (worth D5m) and sell[73] them for L10m (worth D2.5m), with other facts as same. The Afar tax position for the CFC will probably be a nil result (as for Branch below). The Afar tax system "sees"/"perceives" no foreign exchange ("**FX**") gains/losses.

The tax outcome for ResCo at Home will depend on how the Home tax system:

- Recognises or exempts unrepatriated and repatriated earnings of the CFC in Afar (and if recognised, how/how calculated)
- Recognises or exempts gains/losses upon disposal of shares held in the CFC. If recognised:
  - how, and how calculated?
  - what impact/recoupment arises from any previous CFC income attribution from the CFC's earnings?

In <u>some</u> countries (including Australia), ResCo could well end up in "tax nowhere land" as regards the D2.5m economic/cash loss. That is, no tax relief is available in Home (or Afar). This outcome might arise if <u>both</u>:

- Home treats the CFC as undertaking "good" or "active income/business" not requiring attribution; with dividend income also being exempt;

  <u>and</u>

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[72] In practice, hedging by head office of the FX risk on the branch capital may arise. Consistent with the analysis in this Note, tax rules for such hedges (from the perspective of head office) should mirror the tax treatment of hedges undertaken in relation to the FX risk arising from an investment in a foreign subsidiary. Ideally, the timing and tax character of the hedge, in either case, should follow/match the timing and tax character of the investment in the branch or subsidiary.

[73] Or liquidate the CFC, which will be a L10m "cash box".

- gains/losses on shares sold in such an "active" subsidiary (in "good"/"white list" countries) are exempt from capital gains tax or other income tax.

That is, in some countries:

(a) ResCo would not be entitled to a loss[74] when the shares are sold for L10m (worth D2.5m) with a cost base of L10m (worth D5m). (Normally (in most countries) a sale of shares might give to a loss (perhaps capital) of D2.5m; however a loss[75] of the type in question is prevented due to the CGT concession/exemption for any gains, which also denies losses.)

(b) The L10m share sale proceeds have "basis"/cost of D2.5m, so no gain/loss should arise when the L10m is sold for D2.5m in Step 6.

Analysis of the Example

Returning now to the actual facts as posited in the Example.

Afar tax position

The Afar tax position for Branch will probably be a nil result (as for the CFC analogue above). The Afar tax system "sees"/"perceives" no FX gains/losses. This seems reasonable. As far as the Afar tax system can see/cares, everything within its borders/source is denominated in its local currency (L), and Branch makes no gain/loss under its domestic law.

Further, the Afar tax system is unlikely to see any treaty/DTA "issue" or problem with the Afar/Home DTA. That is, it is likely to say there is no need for the treaty/DTA to be amended – it is purely an issue for Home to sort out under its domestic law.

Home tax position

Turning now to the tax implications at Home for ResCo re each of the 6 listed steps:

Step 1: No tax implications – simple spot sale/acquisition of currency at a spot/market rate.

Step 2: Most countries would/should regard this as a "tax nothing", especially if (as posited here) the L10m has been "freshly" (recently) acquired. That is, the L10m has basis/cost equal to its value at the time contributed. *If* the L10m has a different basis/cost to its value at the time that it is contributed as Branch capital, the position is arguably more complex, and is not considered further in this Note.

Step 3: Once again, most countries would/should treat this as a "tax nothing", even ignoring the three alternatives in Step 4 below. That is, goods have been acquired (not yet sold), with no relevant change in the D:L exchange rate.

Step 4: This is where things start getting interesting and difficult! There seem to be at least three major ways that Home's tax system might deal with the sale of goods by Branch:

(a) *Exemption system*: Home might treat some (e.g. "active" etc) branches/ types of income as exempt in Home. No gains/losses will be recognised by ResCo, whether related to "L" price movements or FX gains/losses.

(b) *Taxable/foreign tax credit (FTC) system with "L" as functional currency*: under this system, Home will tax a branch, but only on its net "L" profit, which will be translated into "D" on an average or year-end rate basis.

[74] Any loss, FX-related or otherwise.
[75] Ibid.

On our facts, Branch has no "L" gain/loss and thus nothing is recognised at/by Home.

(c) *Taxable/FTC system without "L" as functional currency*: under this system, Home will tax a branch, but based on point-by-point currency translations. Even here there may be alternatives. However, it appears the traditional/common approach (at least in theory) is that Branch should be regarded as having sales income of D2.5m (then value of L10m) for goods with basis/cost of D5m. Branch thus has a loss of D2.5m which ResCo at Home will presumably treat as a foreign source loss. Different countries will have different rules as to whether this loss has to be quarantined; offset against other foreign income; wasted; usable at Home etc.

In summary, Step 4 may or may not lead to recognition of a tax loss at Home (and if so, the loss may be of variable utility, depending on the precise Home tax rules).

Whether/how *Home* effectively recognises an FX loss inside a Branch (i.e. at Step 4) seems important and should be borne in mind as the other steps are considered and conclusions reached as to whether there is in fact any overall "problem" and if so, what the solution should be: to ensure policy consistency, and no double counting of the loss.

Step 5: This is also interesting and difficult! The first thing to note is that no actual/legal "transaction" occurs. All that happens is that money moves from one bank account of the ResCo legal entity (i.e. that of Branch) to another (i.e. that of ResCo Head Office). ResCo Head Office calls this a "repatriation of Branch (free) capital".

However, note the following:

- The L10m "repatriated" is simply money; there is no separate/other "asset" (analogous to shares in a CFC) that is likely to be recognised by many/any tax systems or by the OECD AOA for branch profit attribution.
- It is not even the same money as contributed at Step 2. It is a different amount of L10m – a different "cup of sugar", to paraphrase that analogy.
- This particular L10m, on our simple facts, can be seen to have basis/cost of D2.5m, i.e. proceeds from the sale of goods at Step 4.

It seems likely that not many, if any, tax systems would recognise a tax event at Step 5 – which is the issue that was disputed in the *Deutsche Shell* case.

Even if (which seems unlikely) a tax system was to recognise a tax event at Step 5 – how exactly would the "event" be defined? The L10m which is repatriated is not the same L10m that was contributed. As noted above, on our facts the L10m repatriated has basis/cost equal to its then value (D2.5m).

Note: If a tax system was to ignore the actual basis/cost for the L10m, and accept that the "branch capital" is a quasi-asset with cost/basis equal to the Step 2 amount (i.e. L10m translated as D5m; thus giving a loss of D2.5m at Step 5), then the ResCo Home tax system would not/should not be adopting the system

described at Step 4(c) above, otherwise double-counting of the one economic loss would occur.

Step 6: It seems likely that most tax systems will not recognise any tax gain/loss at this point – there is a simple spot conversion of L10m for its then value of D2.5m. This L10m has basis/cost of D2.5m. Further, if a tax system doesn't recognise Step 5, it is perhaps unlikely that the addition of Step 6 would cause it to change its mind. On the other hand, if a tax system does recognise a loss at Step 5, then no further loss should arise at Step 6, otherwise double-counting will occur.

Summary of ResCo/Home country treatment of Steps 1 to 6 in the Example

It seems likely that in many, perhaps most, tax systems ResCo will not obtain any tax relief for its economic/cash loss of D2.5m. Certainly, no tax relief could be expected to arise in Afar.

ResCo may get tax relief at Home if Branch is taxable at Home on a point-by-point translation basis for Branch income. Such a loss (D2.5m) is likely to be a foreign source loss, from Branch's operations and may or may not be of much use to ResCo at Home.

If Branch is exempt at Home, or taxable on an "L" functional currency basis, no tax relief for ResCo at Home (or in Afar) appears likely for its economic/cash loss of D2.5m.

Not many, if any, tax systems are likely to regard the mere repatriation of Branch "capital" as giving rise to a taxable event. Even if a loss for such an event was thought possible, query if it could be regarded as Home/domestic rather than Branch/foreign.

Observations, conclusions and recommendations

1. The "Branch capital problem", of the type perceived in *Deutsche Shell* seems to be squarely one for the Home tax system to deal with: at least if capital is in local/Afar currency. There is no problem for the Afar system: it is hard to see why Afar should care. (NB: *If* Afar capital in the Example is in D: further thought is needed!)

2. Accordingly, it is unlikely that DTAs/Conventions can or should seek to "solve" this issue. That is, it is difficult to see what new Article/Commentary etc. should be inserted. Having said this, the OECD could/should ideally still seek to establish best practice and provide guidance/"thought leadership" on the issues, so as to minimise disputes and confusion.

3. A country's tax system ideally should address, with clarity, the treatment of PEs on three "levels":

(a) start-up/dotated capital contributed *and* when eventually repatriated;
(b) income/gains and expenses/losses from branch operations as actually earned; and
(c) repatriation of branch earnings – as distinct from start-up/dotated capital.

(Too often, it seems that (a) is neglected/is "fuzzy" in home country tax systems and perhaps also (c); most of the focus is on (b).)

4. In designing a *comprehensive* tax system for foreign *branches* (i.e. in addressing 3(a), 3(b) and 3(c)), a country should carefully consider its treatment of foreign *subsidiaries* of Home parent entities. Given the economic similarity (albeit different legal status) of a branch to a 100% owned foreign subsidiary, the starting/default position should be to try and replicate subsidiary/CFC rules (being the "easier" or base case) in the case of a branch, or to only depart from the base case on a conscious/well thought out basis.

5. The suggestion at 4. above is consistent with the trend in many countries to try and have consistency between branches and subsidiaries. It is also consistent with the thrust of the OECD's work on PEs, as per the AOA in the OECD Report. (Note however that the OECD Report does not address branch capital in the way/in the depth considered in this Note.

Although, to be fair, and as noted earlier, the "branch capital issue" it is not really a problem for the PE, hence it wasn't really within the scope of the OECD's work on PEs).

6. In order to design rules for branches that mimic rules for subsidiaries/CFCs (see 4. above) it is necessary to have regard to at least all of the following:

(a) How the income of the sub/CFC is treated at Home as earned; e.g.
   (i) not recognised/no CFC attribution/exempt
   (ii) fully attributed on a foreign functional currency basis
   (iii) fully attributed on a point-by-point translation basis
   (iv) variations/partial treatments etc. etc!

(b) How gains/losses on sale of the shares in the foreign sub/CFC are treated at Home; e.g.
   (i) not recognised/exempt
   (ii) capital gain/loss – foreign source
   (iii) capital gain/loss – deemed domestic source
   (iv) some form of concessional/participation exemption treatment
   (v) ordinary income/loss.

(c) Treatment at Home of dividends from foreign subs/CFCs.

7. Once 6(a), 6(b) and 6(c) are understood for the treatment of a foreign subsidiary (or at least for a class of subsidiaries carrying on certain activity in certain countries etc.), then a matching/"sympathetic" system can be designed for a foreign branch of the same class/type (e.g. similar activity, country etc).

8. In other words, there is no one simple, universal solution to the treatment of branches/branch capital. Treatments can/should be expected to vary, just as they do for the treatment of subsidiaries/CFCs. Merely two possible outcomes are set out below by way of example. The first situation produces "tax nothings" for all income/gains/losses of a subsidiary – whether FX or otherwise. In such a situation, the treatment of a branch should be the same. That is, there is nothing "wrong" with a branch capital repatriation giving rise to a "tax nothing", if this is the outcome with a subsidiary. The second situation is more interesting and would be likely to require Home country legislative amendment in domestic law.

9. <u>First situation</u>: Assume that a country treats a class of "good"/"active" subsidiaries/CFCs as fully exempt: i.e. no attribution of income/losses and all gains/losses on sale are exempt – whether FX related or otherwise. Dividend income is exempt. In such a situation, the same treatment should arise for a branch. As well as branch income being exempt, it is reasonable/proper that "tax nothings" should occur on both branch income repatriation and on branch capital repatriation/branch closure etc. – this is the tax outcome as for an economically similar subsidiary. (Note: Home should treat branch capital in a similar way to share capital of a subsidiary for all purposes, including thin capitalisation type rules.)

10. <u>Second situation</u>: Assume that a country taxes gains/losses upon a sale of shares in a foreign subsidiary (such gains/losses would include capital/goodwill values as well as FX movements) but that no recognition/attribution occurs as regards the subsidiary's income during the time that shares are held. Assume also that dividends are exempt at Home. The corresponding treatment for a branch in a similar position (i.e. where a similar policy/outcome is appropriate) should then have three elements:

- Branch income should be exempt when earned at Home and not taxed if repatriated. Such income would not be added to the free capital contributed so as to mimic the position with a subsidiary.
- If branch income still exists and has not been repatriated immediately before branch closure, it should still be treated as exempt, given the ease of ensuring the most beneficial outcome by the company. (In a similar way, if a company has shares which are taxable, where dividends would be exempt, then, anti-avoidance rules aside, it would aim to declare/pay dividends before the shares are sold.)
- The novel part: contributed branch capital (which will need to be tracked/accounted for) should be deemed to be an asset by Home country domestic law, having similar tax attributes to shares in a subsidiary in a similar situation. That is, one would need to determine whether/how to specify if the branch capital asset is a capital or revenue asset; whether gains/losses are treated as domestic or foreign source etc. when

branch contributed capital is repatriated and/or when the branch is closed. Gains/losses would be calculated/dealt with at Home, on the branch capital asset, in a similar way/on a similar basis as shares in a foreign subsidiary would be treated. Such gains/losses would include FX gains/losses and any other capital value movements e.g. if a branch/goodwill was sold to a third party.

11. Hedging: In practice, hedging by head office of the FX risk on the foreign currency denominated branch capital may arise. Consistent with the analysis above, tax rules for such hedges (from the perspective of head office) should mirror the tax treatment of hedges undertaken in relation to the FX risk arising from an investment in a foreign subsidiary. Ideally, the timing and tax character of the hedge should follow/match the timing and tax character of the investment in the branch or subsidiary.[76]

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[76] In this regard, see in Australia the elective tax-hedge regime in Subdiv.230-E, within the TOFA rules in Div.230.