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For the attention of Mr Neil Motteram

30 November 2011

Dear Mr Motteram

### **Submission to Treasury**

#### **Income Tax: Cross border profit allocation: Review of Transfer pricing rules Consultation Paper 1 November 2011**

#### **Specific response in relation Permanent Establishments**

PwC welcomes the opportunity to provide a submission to Treasury in response to the Income Tax: Cross Border Profit Allocation Review of Transfer Pricing Rules Consultation Paper 1 November 2011.

This letter is in addition to our response letter dated 30 November 2011 and deals specifically with the reform of Australia's current rules for attributing profits to Permanent Establishments (PEs), which are an integral part of the transfer pricing rules.

We acknowledge the benefits of clarifying the operation of Australia's transfer pricing rules to ensure they better reflect global best practice and, in particular, latest OECD guidance. Given that Australia's PE attribution rules are part of the broader transfer pricing rules, we do not think it is appropriate that the reform of PE attribution rules is delayed as a separate policy matter but rather should be included within the scope of the other proposed changes to the transfer pricing rules. Not to include it as part of the reform of transfer pricing rules would appear to undermine the overall objective of the Consultation Paper.

We note that Treasury is proposing to make legislative amendments to 'clarify' that a taxing power exists under Australia's double tax treaties effective from 1 July 2004. Arguably, the proposed amendment may result in a self assessment under Article 7 which may import the current OECD guidance on the attribution of profits to PE's depending on which version of the Treaty and Commentary to the Treaty, forms the basis of Australia's DTA with a particular country. Hence, the proposed changes envisaged by the consultation paper may have a flow on impact for PEs which may only add to the uncertainty surrounding this issue.

We consider that legislative action in this area is required immediately and strongly urge that Australia make the necessary legislative and treaty amendments to move to the Authorised OECD Approach (AOA) for allocating profits to PEs. We note that Treasury has already received a submission in 2010 outlining the technical merits and

legislative issues associated with a move to the functionally separate entity approach.<sup>1</sup> We support the views in this paper and believe the key reasons for early legislative action are:

1. The current Australian PE attribution rules based on the “relevant business activity” (RBA) approach is arguably inconsistent with the AOA, being the ‘functionally separate entity’ (FSE) approach. This will increase the compliance risk for multinationals which operate both in Australia and other OECD member countries as they would be required to reconcile the tax outcomes under the two different approaches as well as likely lead to an increase in tax disputes with Australia’s treaty partners and potential double taxation (or less than single taxation).
2. If the latest OECD guidance is only partly adopted, this would produce a potential disparity of outcomes between taxpayers operating through subsidiaries and PEs which is out of step with the OECD consensus view. In our view, the arm’s length principle and OECD guidance should be consistently applied in Australia’s transfer pricing rules to both companies and PEs.
3. If Australia’s PE attribution rules are not aligned with OECD guidance, this may lead to the alienation of the Financial Services Sector which operates mainly through Head Office and PE (branch) structures and contributes significantly to the corporate tax revenues. Furthermore, it would detract from Australia’s stated policy objective of becoming a Financial Services Hub in Asia and reduce its competitiveness internationally.

We set out below some more detailed comments which clearly highlight the need to consider early action to reform Australia’s PE attribution rules.

### *Alignment with OECD guidance*

The international tax principles for attributing profits to a PE are provided in Article 7 of the OECD Model Tax Convention on Income and on Capital which forms the basis of most of Australia’s Double Tax Agreements (DTAs). The OECD published final guidance on how Article 7 should be interpreted in its 2010 report on the attribution of profits to PEs<sup>2</sup>. On the need to provide such guidance, the OECD reflects in this report that:

“Practical experience has shown, however, that there was considerable variation in the interpretation of these general principles and of other provisions of earlier versions of Article 7. This lack of a common interpretation created problems of double taxation and non-taxation”.

The OECD’s guidance reflects the best current international thinking and practice on the application of the arm’s length principle in a PE context, particularly as it relates to banking, global trading and insurance. The current Australian PE attribution rules based on the “relevant business activity” (RBA) approach is the type of variable

<sup>1</sup> Cross Border Dealings within a Single Entity, Tony Frost, Challis Taxation Discussion Group, 5 May 2010.

<sup>2</sup> Organisation for Economic Co-operation and Development, *2010 Report on the Attribution of Profits to Permanent Establishments*, 22 July 2010.

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approach the OECD refers to and are arguably now inconsistent with the Authorised OECD Approach (AOA), being the “functionally separate entity” (FSE) approach.

Australian representatives at the OECD were at the forefront of developing the current OECD approach, so the international business community will expect Australia to adopt the approach approved by the OECD, i.e. the FSE approach.

In this context, it is worthwhile to note that Australia has not recorded any relevant reservation<sup>3</sup> to the new version of Article 7 (including the related Commentary) of the 2010 update of the OECD Model Tax Convention. This would suggest that Australian representatives were expecting that Australia domestic rules would be changed to align to the OECD guidance.

A consequence of not adopting the AOA in domestic law is that for any new or revised DTAs that Australia negotiates with other countries based on the new Article 7, there is the potential for conflict with the existing domestic PE allocation rules.

As such, delaying this move would seem to be at odds with Treasury’s stated policy objective of aligning the domestic profit allocation rules and treaty provisions.

### *Potential for double taxation and increased compliance costs*

Australia’s divergence from the OECD would continue to create confusion and uncertainty for taxpayers. At a time when most of the OECD member countries and also Australia’s treaty partners are moving to adopt OECD guidance, continuing with the current approach any longer carries the risk of significant double taxation (or less than single taxation).

As a result of double taxation, there is increased potential for disputes with Australia’s treaty partners which not only drains taxpayer resources, but also impacts Australia’s reputation in the international community. Where such disputes take place, it is highly likely that many of our treaty partners would insist on the adoption of the OECD approach under a mutual agreement procedure.

If taxpayers wanted to avail themselves of a multilateral Advance Pricing Agreement to seek certainty over their tax position, it is also highly likely that treaty partners would insist on the adoption of the OECD approach.

Besides the potential double taxation, taxpayers face increased compliance costs of reconciling the differing approaches in cases where a multinational operates in both Australia and in a country which adopts the OECD approach.

Across the Asia Pacific region, Australia is often seen as a thought leader in transfer pricing compliance. With the introduction of the International Dealing Schedule (IDS) 2011 and 2012, it also has detailed disclosure requirements with respect to international related party transactions. Within this context, not aligning the PE attribution rules with the AOA will not be well received by the international business community.

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<sup>3</sup> Except the one in relation to insurance profits

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## *Parity in outcomes between subsidiaries and PEs*

Although it is acknowledged that a PE is not the same as a subsidiary, and while the OECD itself recognises that the aim of the AOA is not to achieve equality of outcome between a PE and a subsidiary in terms of *profits*, the objective of the AOA is to apply to dealings within a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises.

Australia's current attribution rules as interpreted by the Commissioner in Taxation Ruling TR 2001/11<sup>4</sup> effectively limits the recognition of some internal dealings between a head office and its branches and where it does recognise the dealing, it only does so to the extent that third party income and expenses can be allocated between a branch and its head office.

Like the Australian guidance, the OECD acknowledges that dealings between a PE and the rest of the enterprise of which it is a part have no legal consequences for the enterprise as a whole, however importantly, the AOA states that:

“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...between independent enterprises<sup>5</sup>.”

An example of the divergence between the Australian and OECD position can be shown in relation to general management or administrative services provided between a head office and its branches. For example, treaty partners adopting the FSE approach would expect to charge a profit mark up on the services provided to Australian branches which arguably would be inconsistent with the current Australian PE rules which would not respect the application of a profit element on such internal dealings.

In our view, the arm's length principle and OECD guidance should be consistently applied in Australia's transfer pricing rules to both companies and PEs. If the latest OECD guidance is only partly adopted, this would produce a potential disparity of outcomes between taxpayers operating through subsidiaries and PEs which is out of step with the OECD consensus view and again at odds with the stated policy objective of aligning the domestic profit allocation rules with international standards.

## *Financial Services sector and Australia as a financial services hub*

Multinationals in the financial services (FS) sector tend to operate through branch structures, and as such, the FS sector, in particular the banks, are possibly the most impacted by PE attribution rules. The FS sector is a significant part of our economy and a large contributor to corporate tax collections. In our view Treasury has the opportunity to adopt the OECD attribution rules in order to bring certainty in the taxation of its cross border dealings. Not doing so would alienate this sector which contributes a significant amount of tax to the Treasury annually.

We note that in Taxation Ruling TR 2005/11, the ATO accepts a “separate entity approach” by recognising ‘internal loans’ as an administrative solution for attributing

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<sup>4</sup> Income tax: international transfer pricing – operation of Australia's permanent establishment attribution rules

<sup>5</sup> Organisation for Economic Co-operation and Development, *2010 Report on the Attribution of Profits to Permanent Establishments*, 22 July 2010, para 173.

profits of a bank from third party funding transactions (akin to the 'trading stock' solution for internal stock transfers). However, a recent ATO paper on the Profit Allocation to Permanent Establishments of Banks, dated 6 July 2011, has indicated that the views expressed in TR 2005/11 do not extend to other notionally internally created financial dealings, which is inconsistent with the AOA. This treatment is also inconsistent with how modern financial institutions carry out their business operations and how they choose to manage risk. The AOA would recognise a derivative as dealing to the extent that it is supported by a functional and factual analysis of the PE and the rest of the enterprise.

We note that an important consideration in designing the new transfer pricing rules is that they should not inhibit Australia's attractiveness as an investment destination. We contend that the uncertainty and divergence from international tax standards impacts the confidence of multinationals to conduct business in Australia. It does not augur well for Australia when one of its stated policy objectives is to be a leading financial services centre in the Asia Pacific region. Many countries have enacted tax reforms to ensure that their economies remain attractive for investment. For example, countries such as Singapore and Hong Kong continue to attract the investment as they use their tax laws to promote these locations as financial services hubs. Australia should respond to increasing international tax competition by reducing the tax complexity and uncertainty through embracing the OECD approach to ensure it can compete in world markets for foreign investment flows.

### *Revenue Impact*

We note from the Consultation Paper that Treasury is keen to assess the revenue impact of adopting the OECD guidance as it relates to PEs. We understand that the Treasury is concerned that a change could lead to substantial leakage of revenue.

In our view, any assessment based on revenue impact would not be equitable and would be prejudicial to taxpayers. In any case, even if the revenue impact could be reliably quantified, we believe that this would not be significant. The major impact of the change would be the benefit of providing clarity over the taxation of PEs.

We understand that one of the tools that Treasury has indicated it will use to assess the revenue impact of adopting the OECD Attribution rules is the new International Dealings Schedule. We are unclear as to how this would be achieved. In our view, the IDS disclosure on branch dealings is not an adequate tool to perform such an assessment.

### *Recommendation*

We recommend that Australia should make the necessary legislative and treaty amendments to move to a functionally separate entity approach for attributing profits as has been adopted by the OECD.

We recommend that this is not treated as a separate policy issue but is included within the scope of the other proposed changes to the transfer pricing rules and be adopted at the same time as the proposed changes to the transfer pricing rules.

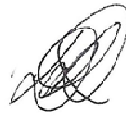
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We would be pleased to discuss the comments in our submission with you further.

Yours sincerely



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