

# ***TR 2005/11 - Income tax: branch funding for multinational banks***

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## Taxation Ruling

### Income tax: branch funding for multinational banks

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Contents	Para
What this Ruling is about	1
Date of effect	8
Ruling	9
Explanation	15
Detailed contents list	53

#### **Preamble**

The number, subject heading, **What this Ruling is about** (including **Class of person/arrangement** section), **Date of effect**, and **Ruling** parts of this document are a 'public ruling' for the purposes of **Part IVAAA of the Taxation Administration Act 1953** and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.

### What this Ruling is about

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#### **Arrangement**

1. This Ruling deals with income tax issues related to the funding of a permanent establishment (PE) of a multinational bank. 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.
2. This Ruling is divided into two parts. The first part focuses on the application to interbranch funds transfers of Australia's PE attribution rules in subsections 136AE(4) to (7) of Division 13 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) and the business profits article in Australia's double taxation agreements (tax treaties). The second part deals with the attribution of equity capital to a PE of a bank and focuses on the interaction of Australia's PE attribution rules and Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997).
3. Our views on the operation of Australia's PE attribution rules are set out in detail in Taxation Ruling TR 2001/11. This Ruling (TR 2005/11) is intended to address issues specifically related to banks. Banks were not dealt with in TR 2001/11.<sup>1</sup>

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<sup>1</sup> See Taxation Ruling TR 2001/11 paragraph 6, however this Ruling does not address global trading.

**Class of persons**

4. This Ruling applies to banks that are multinational enterprises carrying on business through PEs (for example, branches). The Ruling applies to Australian banks with foreign PEs and to foreign banks with Australian PEs. The term 'bank' as used in this Ruling refers to a body corporate that has been granted a banking licence to operate a banking business in Australia as an 'authorised deposit-taking institution' under the *Banking Act 1959*.

5. This Ruling does not apply to a foreign bank (as defined in section 160ZZV of the ITAA 1936)<sup>2</sup> that applies Part IIIB of the ITAA 1936 to calculate its taxable income for that year.

6. This Ruling does not discuss whether there is a PE in existence.<sup>3</sup> Generally, a PE of a bank is a fixed place of business (for example, a branch) through which its business is wholly or partly carried on.

7. 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.

**Date of effect**

8. This Ruling applies from its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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<sup>2</sup> 'Foreign bank' means body corporate that is a foreign ADI (authorised deposit-taking institution) for the purposes of the *Banking Act 1959*: section 160ZZV of the ITAA 1936. Part IIIB of the ITAA 1936 does not apply if an election is made by the foreign bank under subsection 160ZZVB(2).

<sup>3</sup> See Taxation Ruling TR 2002/5.

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## Ruling

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### **Part I – application of Australia’s PE attribution rules to interbranch funds transfers**

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.

### **Part II – attribution of equity capital to a PE of a bank**

10. As Division 820 of the ITAA 1997 is intended as an exclusive code for the matters with which it deals, Australia’s PE attribution rules will not be used to adjust the gearing of a bank that passes the safe harbour test in Division 820.

11. Subject to paragraph 12, the amount of equity attributable to an Australian bank’s foreign branches for Division 820 purposes is the amount actually allocated to them in the bank’s books of account.

12. Where an amount of equity capital allocated to a foreign branch in the bank’s books of account is adjusted for foreign tax purposes or by the Tax Office for other tax purposes, the adjusted amount should be used in the calculation of the equity capital attributable to the branch for Division 820 purposes.

13. Division 820 does not prevent the application of Australia’s PE attribution rules to the pricing of an interbranch loan that is recognised for the purposes of attributing a bank’s income and expense or profit.

14. Where an amount of interest expense is properly attributable to a foreign branch, such an expense is usually incurred in deriving non-assessable non-exempt income under section 23AH of the ITAA 1936 and is therefore not deductible under section 8-1 of the ITAA 1997.

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## Explanation

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### **Part I – application of Australia’s PE attribution rules to interbranch funds transfers**

#### ***Recognition of an interbranch funds transfer – the arm’s length separate enterprise principle***

15. Funds may be transferred internally from one branch of a bank to another with such transfers being characterised and recorded in the institution’s accounts as loans, even though in a legal sense an entity cannot lend to itself.

16. Taxation Ruling TR 2001/11 confirms that Australia's PE attribution rules are based upon allocating a taxpayer's actual income and deductions using an 'arm's length separate enterprise principle'. 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.

17. TR 2001/11 discussed the alternative approach adopted by some countries, specifically referring to the United States case of *National Westminster Bank plc v. USA*,<sup>4</sup> which related to bank interbranch loans. As TR 2001/11 indicates, we do not accept that the business profits article in Australia's tax treaties operates on a strict separate entity basis, which would include recognising bank interbranch loans as transactions giving rise to deductible interest expense.<sup>5</sup>

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.

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<sup>4</sup> 44 Fed. Cl. 120 (1999).

<sup>5</sup> TR 2001/11 paragraphs 1.18 to 1.20.

20. Accordingly, entries in a bank's books of account which reflect arm's length interest charges on interbranch funds transfers are a reasonable and practicable means of determining an arm's length allocation or attribution of third party income or expense of the enterprise.<sup>6</sup>

***Characterising and rewarding functions associated with an interbranch funds transfer***

21. TR 2001/11 prescribes a general approach to attributing profit to a PE that is essentially a two-step process. First, a functional analysis is performed to attribute to the PE, and any other part(s) of the enterprise, the functions performed, assets used and risks assumed by the enterprise in respect of the relevant business activity. Secondly, a comparability analysis is performed to determine an arm's length return for the functions, assets and risks attributed. A dealing between the PE and another part of the enterprise is essentially recognised for the purposes of determining an arm's length attribution of profit to reward the functions performed, assets used and risks assumed by those parts of the enterprise involved in the relevant business activity.

22. This general approach applies where funds are transferred between branches of a bank by determining how this affects the attribution of profits to those branches. Thus, an analysis of the factual circumstances and the functions, assets and risks of the branches will determine how their economic relationship and any interbranch dealing associated with the transfer of funds are to be characterised for the purposes of profit attribution. This will then determine the appropriate separate enterprise analogy for performing a comparability analysis in using an arm's length pricing methodology to attribute profit in respect of the transfer of funds.

23. For instance, the functional analysis may show that the branch transferring the funds made all of the decisions and assumed all of the risks involved in borrowing and lending those funds, so that it is characterised as a principal performing borrowing and lending functions. In such circumstances the transfer of funds may appropriately be characterised as an interbranch 'loan' and the lending branch attributed a return for its borrowing and lending functions through the interest rate margin charged on that loan.

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<sup>6</sup> The deductibility of interest expense so allocated or attributed is subject to the requirement to attribute equity capital as discussed in Part II of this Ruling.

24. On the other hand, the functional analysis may show that one branch is raising funds on behalf of another branch that makes the decision to raise the funds and assumes the associated risks. In such circumstances it is not appropriate to characterise the transfer of funds as a 'loan', and the branch raising the funds may be characterised as performing agency functions and rewarded for the service it performs. This reward may take the form of a separate fee or may be expressed as an interest rate 'turn' on the funds borrowed.<sup>7</sup>

25. It is common for one part of a bank to perform treasury functions related to managing the institution's overall funding position, including funding deficits and investing surpluses, raising funds and making them available within the bank, and managing market risks (interest and currency risks) and liquidity risk. Depending on the circumstances, the functional analysis may show that these treasury functions should be characterised as borrowing and lending functions or as agency or service functions. Thus, treasury functions might be rewarded in particular circumstances either by a margin on the interest rate of an associated interbranch loan, by a separate service fee or an interest rate turn on the funds borrowed, or in some cases by a sharing of associated profit.<sup>8</sup>

***Determining an arm's length reward for functions associated with an interbranch funds transfer***

26. Under the arm's length separate enterprise principle, an interbranch dealing is priced using a functional and comparability analysis applying by analogy an appropriate arm's length pricing methodology. Where the dealing is a loan, a Comparable Uncontrolled Price (CUP) method is likely to be the most appropriate methodology provided there is sufficient reliable data regarding interest rates charged on comparable loans between independent parties. Where the dealing is a service, a CUP or Cost Plus method is likely to be the most appropriate methodology, subject to there being sufficient reliable data regarding charges for comparable services between independent parties.

27. Where the functional analysis shows that an interbranch loan should be recognised, the charging of an arm's length rate of interest on that loan may be used to achieve a profit attribution that accords with the arm's length separate enterprise principle. For instance, where the loan is analogous to a wholesale transaction between independent banks the interest rate might be based upon a suitable market inter-bank rate, for example, LIBOR.

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<sup>7</sup> See paragraph 29.

<sup>8</sup> See paragraphs 23 and 30.

28. In assessing comparability, the terms and conditions of the interbranch loan (for example, principal amount, term, currency, and so on) must be determined, commonly from conduct and the economics of the relationship involved in the interbranch dealing. Where differences exist in respect of the terms and conditions or other circumstances that would be likely to affect the pricing of the loan, these must be accounted for by making comparability adjustments. For example, comparability adjustments may be needed to account for the absence of credit differential on interbranch loans when compared with loans between independent banks. Given that it is a factual and economic condition that all branches generally share the same creditworthiness as the bank as a whole, the interest charge on an interbranch loan should not generally include any premium referable to a variation in credit risk between the branches.

29. In circumstances where an interbranch transfer of funds is traceable to a borrowing by the bank from a third party, the interbranch transfer may appropriately be priced by reference to the pricing of the third party transaction. For instance, in such circumstances where the branch transferring the funds performs borrowing and lending functions, the interest rate charged on the interbranch loan may be determined by adding an arm's length margin rewarding those functions to the interest rate charged on the third party transaction. In some cases it will be appropriate for the interbranch transfer to be priced the same as the third party transaction. For instance, where the branch transferring the funds performs an agency function, the funds may appropriately be transferred at their actual cost to the bank, and the agency function separately rewarded by way of a fee. Alternatively, the reward for the agency function may be expressed as a turn on the interest rate payable on the third party borrowing.

30. A traditional transaction method (for example, CUP or Cost Plus) is likely to be the most reliable basis for rewarding the performance of treasury functions. If necessary, the use of the method may require the making of comparability adjustments, which can affect its reliability. If it is not possible to reliably apply such a method, then a transactional profit method, for example, Profit Split, may be appropriate. This might be the case, for instance, where the treasury functions are so integrated with other functions or across locations that it is not possible to determine an arm's length reward for the treasury functions in isolation.



**Part II – attribution of equity capital to a PE of a bank*****Capital attribution – the arm's length separate enterprise principle***

31. TR 2001/11 states our view that the arm's length separate enterprise principle requires that an adequate level of equity capital be attributed to a PE.<sup>9</sup> This requirement affects the amount of branch funds that can be treated as debt capital. The application of the principle calls for the branch's total funding requirement to be determined, having regard to its functions performed, assets used and risks assumed. The appropriate equity capital component of that requirement must then be determined and attributed, so that the balance of funding required is the amount by reference to which the branch's deduction for interest expense is calculated.

32. We acknowledge that this position differs from that taken in the United States in the case of *National Westminster Bank plc v. USA*.<sup>10</sup> There the court held that for purposes of applying the business profits article of the UK/US tax treaty to an interest deduction of a bank branch, the capital attributable to the branch is the amount in the properly maintained books of account of the branch. We do not accept this decision as determining the position on capital attribution for purposes of Australia's PE attribution rules. In any event, in Australia the issue of how capital attribution affects interest deductibility is dealt with by specific provisions in Division 820 of the ITAA 1997, as discussed below.

***The framework of Division 820 of the ITAA 1997***

33. Division 820 tests the gearing level of a bank's Australian operations to determine the amount of debt deductions (for example, interest expense) allowable to the entity. Division 820 prescribes separate rules for authorised deposit-taking institutions<sup>11</sup> (ADIs) such as Australian banks, and non-ADIs (for example, non-bank institutions). The rules are further divided for Inward and Outward Investing entities (ADIs and non-ADIs).<sup>12</sup>

34. In general terms, for a bank that is an ADI, debt deductions will not be disallowed where its Australian operations has at least the minimum amount of ADI equity capital (equity capital), which under the safe harbour test for ADIs is 4% of the risk-weighted assets of the Australian operations. The safe harbour test operates in a similar manner for both Outward and Inward Investing Entities (ADIs), although for convenience the present discussion focuses on the rules for Outward Investing Entities (ADIs).

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<sup>9</sup> See TR 2001/11 paragraph 3.45.

<sup>10</sup> 58 Fed. Cl. 491 (2003).

<sup>11</sup> Authorised deposit taking institution means a body corporate that is an ADI for the purposes of the *Banking Act 1959*: section 995-1 of the ITAA 1997.

<sup>12</sup> The ADI rules are contained in Subdivisions 820-D and 820-E of the ITAA 1997. The non-ADI rules are contained in Subdivisions 820-B and 820-C, although non-ADIs that satisfy the requirements in Subdivision 820-EA are able to apply the ADI rules.

35. The rules in Division 820 for Outward Investing Entities (ADIs) require that in determining the amount of equity of the Australian operations, the amount of equity capital attributable to the bank's foreign branches be deducted from all the equity capital of the Australian entity. This is done so that only the Australian banking business is tested under the thin capitalisation rules.

Subsection 820-300(3) of the ITAA 1997 uses the term 'attributable' when referring to the amount of equity capital that belongs to the foreign branches and must be deducted to determine the equity capital in the Australian banking business. Subject to paragraph 37, the 'equity capital attributable to the bank's foreign branches will be the amount actually allocated to them'<sup>13</sup> in the entity's books of account,<sup>14</sup> provided that those accounts are properly maintained in accordance with applicable accounting laws and standards. The actual amount allocated to the foreign branch will depend on numerous factors including the capital requirements, if any, in the host jurisdiction.

36. An alternative view is that the acceptance of the amount allocated in the books of account is premised on that amount reflecting the funding required to support the functions performed, assets used and risks assumed by the branches. We do not accept this view as Division 820 is intended to be a safe harbour and the phrase 'equity capital attributable' in this context requires only an allocation as per properly maintained books of account.

37. If the amount of equity capital allocated to the foreign branch in the bank's books of account is adjusted, for example for tax purposes of the host jurisdiction or as a result of an audit adjustment by the Tax Office for other tax purposes, then the adjusted amount should be used in the calculation of the equity capital attributable to the branch.<sup>15</sup> This will ensure that the equity capital in the Australian operations reflects the proper allocation of the entity's capital between Australia and the other jurisdictions in which it operates.

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<sup>13</sup> The Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001 (the EM), paragraph 5.26.

<sup>14</sup> For this purpose 'books of account' includes amounts that are used in the calculation of the ADI equity, and are recorded as such in the *Thin Capitalisation Schedule* lodged for Division 820 purposes. Thus, if a bank has treated capital contributed to a foreign branch as interest free loans in its financial accounts but has identified this amount as equity in its records in doing the calculations for its thin capitalisation schedule, the amount will be regarded as equity for this purpose.

<sup>15</sup> See paragraph 5.26 of the EM.

38. For instance, an Australian bank may be able to comply with the capitalisation requirements of a foreign country by notionally allocating equity capital to its branch in that country purely for tax purposes, rather than allocating capital in its books of account. This may include an adjustment to the bank's taxable profit in that country by reference to a notional equity capital amount. In this situation the bank should use the amount of equity capital as adjusted for foreign tax purposes (for example a notional equity capital amount) as the equity capital attributable to the branch for Division 820 purposes.<sup>16</sup>

39. In light of an adjustment to the amount of equity capital allocated to a foreign branch, the bank will need to reassess its position under Division 820 for the income year in which the adjustment was made, and may need to request an amended assessment for that year.

#### ***The inter-relationship between Division 820 of the ITAA 1997 and Australia's PE attribution rules***

40. Division 820 is intended as an exclusive code for the matters with which it deals, that is, the limiting of debt deductions by reference to the levels of debt and equity capital of the entity.<sup>17</sup> Accordingly, if an ADI passes the relevant safe harbour test in Division 820, Australia's PE attribution rules will not be used to adjust the gearing even if the level of equity capital of the bank's Australian operations is less than an arm's length amount.

41. Division 820 does not prevent the application of Division 13 of Part III of the ITAA 1936 and comparable tax treaty provisions where the pricing of a loan is not arm's length.<sup>18</sup> In a PE context this includes the application of Australia's PE attribution rules to the pricing of an interbranch loan that is recognised for the purposes of attributing a bank's income and expense or profit (for example, interest rates).

#### ***The inter-relationship between Division 820 of the ITAA 1997 and subsection 8-1(2) of the ITAA 1997***

42. Division 820 of the ITAA 1997 does not limit the interest expense deductible to a foreign branch of an Australian bank.<sup>19</sup> The fact that the gearing limits in Division 820 are not breached does not mean that the bank is entitled to a deduction for this interest expense. Where such an expense is incurred in deriving non-assessable non-exempt income under section 23AH of the ITAA 1936 it is not deductible under subsection 8-1(2) of the ITAA 1997. Accordingly, the application of Division 820 is premised upon a bank having determined on an appropriate basis the extent to which its interest expense is incurred in respect of the business conducted through its

<sup>16</sup> The deductibility of the bank's interest expense based on this adjusted foreign branch equity is as discussed at paragraph 45.

<sup>17</sup> See paragraphs 1.76 and 1.77 of the EM.

<sup>18</sup> See paragraph 1.78 of the EM.

<sup>19</sup> See paragraph 1.97 of the EM.

foreign branches, so that only the interest expense that is otherwise deductible under subsection 8-1(2) is subject to Division 820.

43. In practice the debt and equity capital of a bank commonly forms part of a pool of funds available to support the business operations of the bank as a whole. It is not possible to trace or identify any particular monies in this pool as being referable to external borrowings by the bank that have an associated interest expense. It is for this reason that we accept the recognition of arm's length charges on interbranch funds transfers as a means of attributing a bank's interest income and expense for purposes of Australia's PE attribution rules. This provides an appropriate basis for determining the extent to which a bank's interest expense is incurred in respect of the business of its foreign branches for purposes of subsection 8-1(2) of the ITAA 1997.

44. Equity capital is by nature treated as having no associated interest expense. Accordingly, the allocation of equity capital out of an Australian bank's pool of funds to its foreign branches does not give rise to an issue of deductibility of interest expense under subsection 8-1(2) of the ITAA 1997. In practice, where debt funds are raised in Australia and contribute to a pool of funds, some of these funds may ultimately be treated as an allocation of equity capital to a foreign branch. In these circumstances the funds are not traceable to the end use for determining interest deductibility under subsection 8-1(2). Division 820 applies to ensure that the deductibility in Australia of the bank's interest expense is tested by reference to the level of equity capital of the Australian banking business, net of the equity capital allocated to its foreign branches.

45. Where the host country of a foreign branch of an Australian bank does not allow a deduction for an amount of interest expense having regard to the level of equity capital it considers properly attributable to the branch, an issue arises as to whether this amount is deductible to the bank in Australia. Provided the capitalisation of the branch as determined by the host country accords with the business profits article of a relevant tax treaty,<sup>20</sup> this amount of interest expense is not attributable to the branch. Unless this expense is attributable to some other foreign branch of the bank, then it is not incurred in deriving non-assessable non-exempt income under section 23AH of the ITAA 1936 and may be deductible under subsection 8-1(2) of the ITAA 1997 to the extent that the expense is not allocable<sup>21</sup> to a financial instrument that is characterised as 'equity' for purposes of Division 974 of the ITAA 1997.<sup>22</sup> The interest expense deductible under subsection 8-1(2) is subject to the application of Division 820.

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<sup>20</sup> A safe harbour capitalisation approach may accord with the treaty article provided it does not result in the branch being attributed more profit (that is, less interest expense) than if it were allocated an arm's length level of equity capital.

<sup>21</sup> The amount of allocable expense should be determined on a reasonable, practical basis.

<sup>22</sup> For example, a hybrid Tier 1 capital instrument issued by the bank out of a foreign branch.

**Practical application of Australia's PE attribution rules, Division 820 of the ITAA 1997 and subsection 8-1(2) of the ITAA 1997***Interbranch funds transfer – Australian head office to offshore PE*

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.

*Interbranch funds transfer – offshore PE to Australian head office*

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

*Equity capital attributable to offshore PE*

48. In contrast to the previous examples, where a bank attributes equity capital to a foreign branch for purposes of subsection 820-300(3), no interbranch loan arises. Accordingly, repatriation of any profits by the foreign branch in respect of that equity does not constitute an interbranch interest charge and will not give rise to an allocation of assessable income to the bank's Australian head office. This is so regardless of how the allocation of equity or the repatriation of profits are treated for financial accounting or tax purposes in the foreign country.

### ***Documentation requirements***

49. A taxpayer carrying on a business through a PE must keep records evidencing the basis for allocation of income, expenditure, assets, liabilities and capital, as well as the attribution of profits to a PE.<sup>23</sup>

50. Taxation Ruling TR 98/11 addresses the documentation requirements for demonstrating compliance with the arm's length principle in dealings between separate entities. These requirements are relevant to intra-entity dealings to the extent that the processes involved in selecting and applying the accepted arm's length pricing methodologies are relevant to those dealings.

51. Taxation Ruling TR 2001/11, in particular paragraphs 4.46 to 4.51, discusses the documentation requirements for Australia's PE attribution rules. A bank's books of account will be the starting point in attributing income, expense and funding to its branches. However, the accounts will only determine attribution for purposes of Australia's PE attribution rules where they accord with economic substance, having regard to the functions performed, assets used and risks assumed by the branches.

52. As interbranch dealings do not create a legal relationship between branches (see paragraph 15), there will not be legal contracts evidencing these dealings. The terms and conditions, including pricing, of interbranch funds transfers may be evidenced by internal records such as management accounting systems including electronic confirmation systems such as the Reuters Dealer system.

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<sup>23</sup> See section 262A of the ITAA 1936. Note also the requirements applicable to Inward Investing ADIs under Subdivision 820-L of the ITAA 1997.

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## Detailed contents list

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53. Below is a detailed contents list for this draft Taxation Ruling:

	<b>Paragraph</b>
<b>What this Ruling is about</b>	<b>1</b>
Arrangement	1
Class of persons	4
<b>Date of effect</b>	<b>8</b>
<b>Ruling</b>	<b>9</b>
Part I – application of Australia’s PE attribution rules to interbranch funds transfers	9
Part II – attribution of equity capital to a PE of a bank	10
<b>Explanation</b>	<b>15</b>
Part I – application of Australia’s PE attribution rules to interbranch funds transfers	15
<i>Recognition of an interbranch funds transfer – the arm’s length separate enterprise principle</i>	15
<i>Characterising and rewarding functions associated with an interbranch funds transfer</i>	21
<i>Determining an arm’s length reward for functions associated with an interbranch funds transfer</i>	26
Part II – attribution of equity capital to a PE of a bank	31
<i>Capital attribution – the arm’s length separate enterprise principle</i>	31
<i>The framework of Division 820 of the ITAA 1997</i>	33
<i>The inter-relationship between Division 820 of the ITAA 1997 and Australia’s PE attribution rules</i>	40
<i>The inter-relationship between Division 820 of the ITAA 1997 and subsection 8-1(2) of the ITAA 1997</i>	42
<i>Practical application of Australia’s PE attribution rules, Division 820 of the ITAA 1997 and subsection 8-1(2) of the ITAA 1997</i>	46
<i>Documentation requirements</i>	49
<b>Detailed contents list</b>	<b>53</b>



*Previous draft:*

TR 2005/D1

*Related Rulings/Determinations:*

TR 92/1; TR 92/20; TR 97/16;  
TR 98/11; TR 2001/11; TR 2002/5

*Subject references:*

- allocation of assets, liabilities and capital
- allocation of income and expenditure
- arm's length principle
- attribution of profits
- Australian banks
- banks
- business profits
- capital allocation
- cost plus method
- cross border dealings
- 'CUP' method
- determinations (Div 13)
- double tax agreements
- exemption of foreign branch profits
- functional analysis
- interbranch lending
- inter-segment charges
- intra-entity dealings
- permanent establishments
- profit split method
- source of income
- transfer pricing
- use of accepted transfer pricing methodologies

*Legislative references:*

- ITAA 1936 23AH
- ITAA 1936 Pt III Div 13
- ITAA 1936 136AE(4)
- ITAA 1936 136AE(5)

- ITAA 1936 136AE(6)
- ITAA 1936 136AE(7)
- ITAA 1936 Part IIIB
- ITAA 1936 160ZZV
- ITAA 1936 160ZZVB(2)
- ITAA 1936 262A
- ITAA 1997 8-1
- ITAA 1997 8-1(2)
- ITAA 1997 Div 820
- ITAA 1997 Subdiv 820-B
- ITAA 1997 Subdiv 820-C
- ITAA 1997 Subdiv 820-D
- ITAA 1997 820-300(3)
- ITAA 1997 Subdiv 820-E
- ITAA 1997 Subdiv 820-EA
- ITAA 1997 Subdiv 820-L
- ITAA 1997 Div 974
- ITAA 1997 995-1
- TAA 1953 Pt IVA
- Banking Act 1959

*Case references*

- National Westminster Bank plc v. USA 44 Fed. Cl. 120 (1999)
- National Westminster Bank plc v. USA 58 Fed. Cl. 491 (2003)

*Other references*

- Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001
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NO: 2004/11150  
ISSN: 1039-0731  
ATOlaw topic: Income Tax -- Deductions -- interest expenses  
Income Tax -- Tax integrity measures -- thin capitalisation