



31 May 2024

Fiona Knight
Deputy Commissioner of Taxation
Public Groups & International
Australian Taxation Office

Attention: James Campbell

Dear Ms Knight

**Thin Capitalisation
Attribution of Risk Weighted Assets to Australian Branches of Foreign Banks**

The Australian Financial Markets Association (**AFMA**) represents the interests of over 130 participants in Australia's financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. AFMA's members are the major providers of wholesale banking and financial market services to Australian businesses and investors.

We are pleased to lodge a submission to the ATO's Discussion Paper titled "Thin Capitalisation – Attribution of Risk Weighted Assets to Australian Branches of Foreign Banks" (**the Discussion Paper**). It is acknowledged that the ATO has issued a Discussion Paper for the purpose of commencing a dialogue with industry regarding the appropriate determination of risk-weighted assets for Australian branches of foreign banks and our submission is written in the spirit of furthering this dialogue. AFMA reserves the right to seek further technical advice to support the industry position in the future, if necessary.

Executive Summary

AFMA notes the following by way of executive summary:

- AFMA supports, and has always supported, appropriately prepared APRA branch accounts as the source of truth for the attribution of risk-weighted assets for the purposes of Division 820, noting with approval the approach adopted to the attribution of capital in TR 2005/11;
- We are concerned with the current ATO position that emphasises significant person functions as the determinant of the location of attribution of risk-weighted assets as:

- There is no hierarchy in the current position to assist the determination where significant people functions are undertaken in multiple jurisdictions;
- The commentary that supports the current ATO position has been explicitly not endorsed by Australia;
- The current ATO position should address the attribution of risk-weighted assets only, and considerations of notional funding to support the booking of assets and associated interest withholding tax issues are beyond the scope of the paper; and
- The ATO position, when finalised, should apply prospectively in substance, such that the booking location for existing assets is respected.

Presumptive Reliance on Books of Account

AFMA has always supported, and continues to support, that the *prima facie* source of truth as to the financial position of the Australian branch of a foreign bank is the report provided to APRA. Reliance on the APRA reports acknowledges the key role undertaken by prudential regulators in relation to ADIs and the regulatory efficiency associated with there being one source of truth for different regulatory purposes. AFMA concedes that no reliance should be placed on branch accounts that are improper or not prepared in accordance with accounting standards; however, engagement with the ATO has confirmed that the office has no concerns with the quality of branch accounts lodged with APRA by Australian branches of foreign banks.

On this basis, AFMA continues to support the position expressed in Taxation Ruling 2005/11 which accepts, for the purpose of attribution of equity capital to a permanent establishment of a bank, that “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.” There is a caveat to this position, namely where there has been an adjustment of the allocation of equity capital for foreign tax purposes necessitating an adjustment in the Australian books of account, but in the absence of any such adjustment, the books of account represent the source of truth for the determination of equity attributable to branches for Division 820 purposes.

Further, it is noted that the approach adopted by key trading partners, such as Japan and Hong Kong, is to rely on the branch accounts as the determinant of where the assets are to be attributed. Any alternate approach adopted in Australia may serve to exacerbate asymmetry in terms of attribution between different jurisdictions.

We disagree with the distinctions made in the Discussion Paper to the positions articulated in TR 2005/11. In our view, the analysis as to whether it is equity capital or risk-weighted assets that are attributed to a branch for thin capitalisation purposes should be consistent and any distinction between the two is, in our view, arbitrary. We also note the comments in paragraph 32 that suggest that merely because the branch accounts need to be prepared in accordance with applicable laws and accounting standards, then this does not suggest that the branch accounts are not acceptable *per se*. It is not the case and has never been the case that branches can rely on improperly prepared branch accounts and this is not AFMA’s suggested approach.

ATO Approach – Significant People Functions

AFMA acknowledges the ATO’s current position, as articulated in the Discussion Paper, as being that “an asset is attributable to the place where the significant people functions are carried out.” Such significant people functions are said to include:

- The origination of the loan, including negotiating contractual terms, evaluating risks, assessing creditworthiness and committing the bank to the loan; and
- The management of the loan including ongoing assessment of risk, management of the risk and potential intervention in the event that there is doubt as to whether the loan remains viable.

While the current ATO position is not AFMA’s preferred approach, our comments in respect of this approach are set out below:

No Hierarchy of Significant People Functions

A primary issue with the ATO’s current approach is that it assumes that the significant people functions are undertaken in the same jurisdiction. In practice, this is unlikely to be the case, such as where an Australian branch of a foreign bank originates a loan with an Australian counterparty, but the ongoing management of that loan is centralised in head office or another part of the enterprise. In such circumstances, the Discussion Paper is silent as to whether the ATO views one significant people function as more significant than the other, so as to be determinative for attribution purposes.

It should also be noted that there may be different considerations to take into account in the assessment of significant people functions depending on the asset class and type of risks applicable to the asset.

OECD Guidance to Support ATO Position

AFMA notes that the ATO has referenced OECD guidance to support its current position, namely that that location of significant people functions is the appropriate location for attribution of assets. It is further noted, however, that the OECD guidance that is referred to in the paper is the 2010 guidance, which endorses the current authorised-OECD approach to branch attribution, namely the functional separate entity approach.

Australia has rejected the current authorised OECD approach and has explicitly reserved “the right to use the previous version of Article 7, i.e. the version that was included in the Model Tax Convention immediately before the 2010 update of the Model Tax Convention. (Australia does) not, therefore, endorse the changes to the Commentary on the Article made through that update.” That is, Australia has not only rejected the current authorised OECD approach with respect to Article 7 of the OECD Model Tax Convention, it has also not endorsed the commentary that supports the current authorised OECD approach.

On that basis, AFMA’s view is that the ATO is unable to rely on 2010 OECD commentary to support its current position. The ATO should review the commentary that relates to the previous Model Tax Convention to ascertain whether such commentary provides support for the current ATO position.

Current Position only Addresses Loans

AFMA notes that the Discussion Paper, both in its articulation of significant people functions and also in each of its examples, focusses solely on lending activity and is silent on other transactions

that banks (including Australian branches of foreign banks) may enter into with clients, such as derivatives. Accordingly, it is unclear as to whether the ATO's current position is solely in relation to loans or extends to assets more generally.

Scope of the Discussion Paper

AFMA notes that the ATO's articulation as to the scope of the Discussion Paper is (at paragraph 7)

“about the safe harbour formula used to work out the minimum capital amount of inward investing entities (ADIs). It outlines our suggested view on how to work out that part of the RWAs attributable to a branch of a foreign bank.”

AFMA agrees that the scope of the paper should be limited only to determine the risk-weighted assets attributable to an Australian branch of a foreign bank for the purposes of Division 820, and nothing more. Specifically, it is beyond the scope of both the Discussion Paper and Division 820 that, in the event that an asset is attributed to an Australian branch of a foreign bank for thin capitalisation purposes, to notionally attribute funding of those assets, with the potential for notional interest withholding tax to apply to the costs of that notional funding, as is suggested in paragraph 52.

Comments in Taxation Ruling TR 2005/11 are supportive of this position. At paragraph 40, the Ruling states “Division 820 is intended as an exclusive code for the matters with which it deals, that is, limiting debt deductions by reference to the levels of debt and equity capital of the entity...Australian'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” Further “Division 820 does not prevent the application of the (former) Division 13 of Part III of the ITAA 1936 and comparable tax treaty provisions where the pricing of the loan is not at arm's length.”

These comments highlight that Division 820 and Division 815 address different objectives; while Division 815 is aimed to ensure that related party dealings are based on arm's length dealings, Division 820's sole remit is to determine whether a taxpayer holds sufficient equity in Australia such that the thin capitalisation provisions do not operate to deny debt deductions. Accordingly, it is AFMA's view that, should an asset that is booked on a balance sheet outside of Australia be attributed to the Australian balance sheet, then this should not result in any additional attribution, given that Division 820's status as an exclusive code for assessing whether sufficient equity is held in Australia.

Application of ATO Position

While we agree with the current position articulated in the Discussion Paper that the final position of the ATO should only be applied prospectively, we disagree that this approach should apply to assets that are in existence prior to the finalisation of the ATO's position and would prefer that the attribution of existing assets be grandfathered. Depending on the ATO's final position, the compliance burden to revisit the justification for the booking location of existing assets could be significant and disproportionate to the risks that the ATO is seeking to address. Applying the final ATO position prospectively in relation only to new assets would allow for affected banks to operationalise the ATO's requirements in terms of both attribution and documentation.

AFMA's Preferred Approach

In engaging with the ATO in relation to the appropriate method of attribution of risk-weighted assets to Australian branches of foreign banks, it is appropriate for AFMA to set out its preferred position to assist with ongoing engagement with the ATO.

As noted above, AFMA supports the branch accounts that an Australian branch of a foreign bank appropriately prepares and lodges with APRA being the source of truth for the attribution of risk-weighted assets for the purposes of Division 820. We acknowledge that the branch accounts will need to be prepared in accordance with Australian accounting standards and be consistent with APRA's requirements regarding the booking of Australian business in the Australian branch, including the limited exceptions that allow for such business to be booked offshore.

To augment the position articulated in the branch accounts, Australian branches of foreign banks should have contemporaneous documentation that sets out the basis for the choice of booking location and the rationale for why that is consistent with the expectations of APRA and other prudential regulators, such as that which supervises head office. To the extent that this documentation is not available then it would be open to the ATO to assess whether the booking location for a certain asset is appropriate.

AFMA's view is that this approach is consistent with Division 820, paragraph 4.38 of the Explanatory Memorandum and the approach adopted in TR 2005/11.

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Thank you for the opportunity to provide a submission in relation to the Discussion Paper. Please contact me on (02) 9776 7996 or at rcolquhoun@afma.com.au to discuss any of the matters that we have raised in this submission.

Yours sincerely,



Rob Colquhoun
Head of Tax