


TD 2002/D6 - Income tax: when can a foreign bank elect not to apply Part IIIB of the Income Tax Assessment Act 1936 (ITAA 1936) in calculating the taxable income attributable to the activities of its Australian branch?

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This document has been finalised by TD 2002/28.

Draft Taxation Determination

Income tax: when can a foreign bank elect not to apply Part IIIB of the *Income Tax Assessment Act 1936* (ITAA 1936) in calculating the taxable income attributable to the activities of its Australian branch?

Preamble

Draft Taxation Determinations (DTDs) present the preliminary, though considered, views of the Australian Taxation Office. DTDs should not be relied on; only final Taxation Determinations represent authoritative statements by the Australian Taxation Office.

1. This draft determination applies to income years commencing after 30th June 1994 and up to, but not including, the income year commencing after 1st July 2001.
2. The provisions of Part IIIB of the ITAA 1936 assist a foreign bank in calculating the taxable income referable to certain activities of its Australian branch. A foreign bank can elect not to apply Part IIIB in circumstances where a Double Tax Agreement (DTA) is applicable to the bank, and in determining the taxable income of the Australian branch for the year of income, the outcome for the bank would be more favourable under the DTA than if the provisions of Part IIIB were applied in their entirety (subsection 160ZZVB(2) of the ITAA 1936).¹
3. In determining whether a more favourable outcome is obtained under the DTA, the foreign bank must first determine what the taxable income of the Australian branch would be on the basis of the provisions of Part IIIB, and compare that to what the taxable income of the branch would be under the DTA.
4. In determining the taxable income of the Australian branch in accordance with the provisions of Part IIIB, the foreign bank must reduce any allowable deduction for interest incurred by the Australian branch by the *notional equity requirement* (calculated under subsection 160ZZZB(2)).
5. In determining the taxable income of the Australian branch under the DTA, and specifically the *Business Profits* Article, the taxable income of the branch is to be calculated

¹ See Supplementary Explanatory Memorandum to Income Tax Assessment Bill (No.3) 1994, Chapter 5, paragraph 5.4.

on the basis that it operates as a distinct and separate enterprise dealing at arm's length with the foreign bank of which it is a part, and other enterprises with which it deals.² In this respect it is important to recognise that an independent enterprise operating a banking business would usually be required to have equity capital.³

6. Accordingly, having regard to the facts and circumstances of the Australian branch, the foreign bank should take equity capital into account in calculating the allowable interest expenses.⁴ The Commissioner's view is that in determining the taxable income of the branch under the DTA, the branch should not have less equity capital than would be required by the *notional equity requirement* calculated under subsection 160ZZB(2) of Part IIIB. Zero capital would therefore not be an acceptable position for the branch of a foreign bank to adopt.

7. In circumstances where the DTA does not produce a more favourable outcome for the foreign bank, the election in Part IIIB cannot operate, and the provisions of Part IIIB must be applied to calculate the taxable income attributable to the activities of the Australian branch. If a foreign bank has allocated capital to the Australian branch that is less than the equity capital required by the *notional equity requirement*, it may still be possible to elect to be taxed under the DTA, if after taking capital into account, it produces a more favourable outcome. In this situation, the ATO would disallow interest deductions so that the allocated capital, and the amount of capital on which interest deductions are disallowed, are at least equal to the equity capital that would be required by the *notional equity requirement* under Part IIIB.⁵

Your comments

8. We invite you to comment on this draft Taxation Determination. We are allowing 4 weeks for comments before we finalise the Determination.

Comments by Date: 28 June 2002

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² See Taxation Ruling TR 2001/11 for a detailed discussion of Australia's permanent establishment attribution rules, and for general guidance on the operation of the *Business Profits* Article as it applies to permanent establishments see the Commentary to Article 7 in the OECD Committee on Fiscal Affairs, Model Tax Convention on Income and Capital, Paris, (loose leaf).

³ See also paragraph 3.45 of TR 2001/11.

⁴ See the 1984 Report of the OECD Committee on Fiscal Affairs entitled *Transfer Pricing and Multinational Enterprises- Three Taxation Issues*, which discusses the disallowance of interest on capital allocated to bank branches. See especially paragraphs 80-81 of the Report.

⁵ See footnote 4.

Commissioner of Taxation

29 May 2002

Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

TR 2001/11

Subject references:

- Australian branches of foreign banks
- Business Profits Article
- capital allocation
- Double Tax Agreements
- foreign banks
- notional equity requirement

Legislative references:

- ITAA 1936 Part IIIB
- ITAA 1936 160ZZVB(2)
- ITAA 1936 160ZZB(2)

Other references:

- The Parliament of the Commonwealth of Australia, Explanatory Memorandum to Income Tax Assessment Bill (No.3) 1994.
- OECD Committee on Fiscal Affairs, Commentary on Model Tax Convention on Income and Capital, OECD, Paris (loose leaf).
- OECD Committee on Fiscal Affairs, Discussion Draft on Attribution of Profit to Permanent Establishments (February 2001).
- OECD Committee on Fiscal Affairs, Model Taxation Convention: Attribution of Income to Permanent Establishments; Issues in International Taxation No.5, OECD, Paris, 1994.
- OECD Committee on Fiscal Affairs, Transfer Pricing and Multinational Enterprises: Three Taxation Issues, OECD, Paris, 1984.

ATO References

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