


PCG 2018/1 - ATO compliance approach - attribution of ADI equity capital and controlled foreign entity equity

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ATO compliance approach – attribution of ADI equity capital and controlled foreign entity equity

Relying on this Guideline

This Practical Compliance Guideline sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow this guideline in good faith, the Commissioner will administer the law in accordance with this approach.

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What this Guideline is about

1. This Guideline sets out how the ATO will administer subsection 820-300(3) of the *Income Tax Assessment Act 1997* (ITAA 1997)¹ in the context of a taxpayer's calculation of its 'adjusted average equity capital'.

¹ All legislative references in this Guideline are to the ITAA 1997 unless otherwise specified.

2. Subsection 820-300(3) defines the term 'adjusted average equity capital' for the purposes of subsection 820-300(1).

3. This Guideline consists of two parts. Part A is concerned with the attribution of ADI equity capital to a permanent establishment (PE) for the purposes of paragraph 820-300(3)(a). Part B is concerned with the attribution of controlled foreign entity equity to a PE for the purposes of paragraph 820-300(3)(b).

Date of effect

4. This Guideline is relevant to you from your first income year that commences after the Guideline's date of issue. We will review the use and application of this Guideline over the next three years. We will consult in relation to any proposed material changes to the Guideline.

PART A: ATTRIBUTION OF ADI EQUITY CAPITAL TO AN OVERSEAS PERMANENT ESTABLISHMENT

Introduction

5. Subsection 820-300(1) is the operative provision for disallowing debt deductions for outward investing ADIs. An ADI will not have all or part of each debt deduction disallowed provided that the entity maintains its 'adjusted average equity capital' at a level that is at least equal to its 'minimum capital amount'.

6. Subsection 820-300(3) defines the term 'adjusted average equity capital' (AAEC). It includes the average value of the entity's 'ADI equity capital' for the relevant year other than the ADI equity capital **attributable** to the overseas PEs of the entity.

7. In Taxation Ruling TR 2005/11 *Income tax: branch funding for multinational banks*, the Commissioner explains at paragraph 35 that (emphasis added):

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' in the entity's books of accounts, provided that those accounts are properly maintained in accordance with applicable accounting laws and standards.

8. Paragraph 37 of TR 2005/11 provides that (emphasis added):

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. 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.

9. The explanation of what constitutes ADI equity capital attributable to a PE in TR 2005/11 needs to be elaborated upon in two key respects. First, what is meant by the reference to a bank's book of accounts being 'properly maintained in accordance with applicable accounting laws and standards'; and secondly, what is meant when it is said that the amount of ADI equity capital recorded in a bank's book of accounts has been adjusted for 'foreign' or 'other tax purposes'.

Book of accounts properly maintained in accordance with applicable accounting laws and standards

10. The requirement that the amount of ADI equity capital is the amount allocated in a bank's book of accounts provided that the book of accounts is properly maintained in accordance with applicable accounting laws and standards is, on its face, odd given that Australian accounting standards do not require (or have not previously required) stand-alone accounts to be prepared for foreign PE operations.

11. However, there are circumstances where such accounts are prepared as a matter of commercial practice. Two circumstances where an Australian entity with an overseas PE will need to prepare stand-alone accounts are:

- (i) where a regulatory body of the jurisdiction in which a PE is located requires the preparation and lodgment of accounts, and
- (ii) in respect of the preparation of consolidated accounts for the Australian entity that are mandated by the relevant Australian accounting standard.

12. We consider that, in the first instance, accounts prepared for the purposes of satisfying a host jurisdiction's regulatory requirements will suffice in terms of establishing that a book of accounts has been properly maintained in accordance with applicable accounting laws and standards.

13. In the event that such accounts have not been prepared, we consider that stand-alone accounts that have been prepared for the purposes of inclusion in a consolidated set of accounts will also suffice.

Adjustments to equity capital for foreign tax purposes

14. We take the view that the reference in TR 2005/11 to adjustments made to ADI equity capital for 'foreign tax purposes' will include any adjustment made to ADI equity capital allocated to an overseas PE so as to comply with the tax laws of the jurisdiction in which that PE is located.

15. For example, if an Australian bank has an overseas PE in a jurisdiction that imposes a comparable thin capitalisation requirement to that imposed on foreign banks by subsection 820-395(1), then it is clear that any additional allocation of ADI equity capital that is made to comply with that requirement will be an adjustment for 'foreign tax purposes'. That is not to say, however, that adjustments for foreign tax purposes are necessarily confined to such instances. There may be other instances where ADI equity capital has been adjusted for foreign tax purposes.

ATO adjustments to equity capital for other tax purposes

16. The reference in paragraph 37 of TR 2005/11 to adjustments being made to ADI equity capital by the ATO clearly contemplates the possibility that the amount of ADI equity capital that has been allocated to a PE in a bank's book of accounts may be adjusted by the ATO for 'other tax purposes' in some circumstances, so as to reflect the ATO's view on the appropriate amount of ADI equity capital that should be attributed to a PE. The reference to **other** tax purposes indicates that adjustments can be made to reflect the application of any part of the income tax legislation other than Division 820 itself.

17. While in most cases it is expected that the Commissioner will accept that the amount of ADI equity capital allocated to an overseas PE in the book of accounts is equal to the amount actually attributable, there may be circumstances where the Commissioner reviews the ADI equity capital allocated and determines that the amount allocated to a PE does not accord with the amount properly attributable to that PE for the purposes of a particular part of the income tax legislation (other than Division 820). If, by way of illustration, a non-share equity interest has been issued through an offshore PE and the funds from that issuance are not classified as equity in the accounts of the PE then presumably an adjustment to the amount of equity that has been allocated in the accounts can be made upon the basis of 'other tax purposes'. In such a case it is open to the Commissioner to substitute, for the purposes of applying Division 820, the amount of ADI equity capital allocated in any book of accounts that has been prepared.²

18. We note that the Commissioner will also be able to substitute an amount of ADI equity capital in instances where the book of accounts for an offshore PE has not been properly maintained in accordance with applicable accounting laws and standards, within the meaning of that requirement as described at paragraphs 12 and 13 of this Guideline.

ATO adjustments to equity capital for Division 820 purposes – a suggested proxy

19. We will seek to administer section 820-300 on the basis of our view that the minimum amount of ADI equity capital that must be allocated to an overseas PE of an ADI should approximate the value of the ADI's assets that are attributable to the business carried on at the PE, less the ADI's liabilities that are attributable to that business.

20. In terms of a proxy that gives rise to a reasonable approximation of the minimum ADI equity capital that must be allocated to an overseas PE for the purposes of paragraph 820-300(3)(a) we will accept an amount which is calculated using the methodology in paragraph 21 of this Guideline, which is based on the method statement in section 820-405. Adoption of this proxy will ensure that there is consistency in terms of the minimum allocation of ADI equity capital for Australian banks with overseas PEs and the minimum ADI equity capital that would reasonably be expected to be allocated by foreign banks to their Australian PEs for thin capitalisation purposes (to avoid a denial of debt deductions).

21. The relevant methodology is as follows:

- Step one – work out the value, for the income year, of that part of the risk-weighted assets of the Australian bank that is attributable to the overseas PE at or through which it carries on its banking business in the relevant foreign jurisdiction.
- Step two – multiply the result of step one by 6%.

22. If the amount of ADI equity capital that arises under the methodology exceeds the amount that has been allocated to an overseas PE in a bank's book of accounts which are subject to review then the amount that arises under the methodology should take precedence.

23. If, however, an amount of ADI equity capital has already been allocated to an overseas PE for foreign tax purposes or by the Commissioner for tax purposes other than Division 820 and that amount (or, if there is more than one allocation, the greater of those amounts) equals or exceeds the amount that would be allocated under the methodology then it will not be necessary to allocate any additional ADI equity capital to the overseas PE.

² This should not be taken as an indication that an adjustment made to ADI equity capital can only ever involve an increase in the ADI equity capital that has been allocated to an overseas PE.

PART B: ATTRIBUTION OF CONTROLLED FOREIGN ENTITY EQUITY TO AN OVERSEAS PE

Introduction

24. Subsection 820-300(3) requires an entity's 'controlled foreign entity equity' (CFEE) to be taken into account in calculating its AAEC to the extent it is not CFEE that is **attributable** to the overseas PEs of the entity.

25. The Commentary to Article 7 of the OECD's *Model Tax Convention on Income and Capital*, which is concerned with the attribution of business profits to the PE of an enterprise, provides some useful guidance for establishing whether CFEE is an asset that is attributable to a PE. The Commentary calls for a functional analysis of the business carried on at the PE.

26. Article 7 provides that (emphasis added):

2. For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable ... to the permanent establishment ... 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.

Commentary to Article 7

27. Reference is made in the second paragraph of Article 7 to taking account of the functions performed, assets used and risks assumed by the enterprise at the PE in carrying on business in order to quantify the profits that are attributable to the PE.

28. Paragraphs 20 and 21 of the Commentary to Article 7 elaborate on how to identify the assets that have been used by an enterprise at a PE. Those paragraphs provide, respectively, as follows (emphasis added):³

20. As explained in the **Report**, the attribution of profits to a permanent establishment under paragraph 2 will follow from the calculation of the profits (or losses) from all its activities, including transactions with independent enterprises, transactions with associated enterprises ... and dealings with other parts of the enterprise. This analysis involves **two steps** which are described below...
21. Under the first step, a functional and factual analysis is undertaken which will lead to:
- the attribution to the permanent establishment, as appropriate, of the rights and obligations arising out of transactions between the enterprise of which the permanent establishment is a part and separate enterprises;
 - **the identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the permanent establishment;**
 - **the identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the permanent establishment;**
 - the identification of other functions of the permanent establishment;
 - the recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognized...
 - the attribution of capital based on the assets and risks attributed to the permanent establishment.

³ The 'Report' referenced within this quote is a reference to the OECD's *2010 Report on the attribution of profits to permanent establishments*.

29. In the case of CFEE this means, therefore, that economic ownership of CFEE can be attributed to the overseas PE of an Australian bank where it can be demonstrated that (i) the creation (where relevant) and management of the CFEE in question is conducted by personnel located at the relevant overseas PE, and (ii) the risks associated with the CFEE are managed by personnel located at the relevant overseas PE.

CFEE attributable to overseas PE – a proxy

30. If an outward investing entity (ADI) undertakes a functional analysis and can establish that **economic ownership** of a particular amount of CFEE is attributable to an overseas PE then we are of the view that that will be sufficient for the purposes of demonstrating compliance with the requirements of paragraph 820-300(3)(b). A practical example as to how this might be done is set out in paragraphs 33 to 40 of this Guideline.

31. It needs to be emphasised that we are not saying that it is a legislative requirement of paragraph 820-300(3)(b) to perform a functional analysis. What we are proposing is a method, which is acceptable to the ATO, by which to identify the CFEE that is attributable to an overseas PE for the purposes of paragraph 820-300(3)(b).

32. The Commissioner will generally accept that the CFEE that is recorded as an asset in a PE's book of accounts is attributable to that PE, on the basis that the CFEE is used by the enterprise in carrying on business at the PE. In other words, the CFEE is necessarily connected to the profit making activities carried on at the PE. However, the Commissioner is not bound to accept the amount in the book of accounts as it is possible that the book of accounts may not correctly record whether CFEE is in fact attributable for the purposes of paragraph 820-300(3)(b). This may be the case, for example, where the book of accounts has not been prepared in a manner consistent with a functional analysis.

Example – an illustrative transaction

33. *Bank Co is an authorised deposit taking institution, and an Australian resident for income tax purposes. It is also an outward investing entity (ADI) for the purposes of Subdivision 820-D.*

34. *The head office of Bank Co is based in Sydney (Sydney Head Office), and it has a PE located in London (the London PE). Sub Co is a foreign shelf company and a 100% owned subsidiary of Bank Co, with 10 £1 ordinary shares on issue. In January 2013 Bank Co decided to subscribe for 20 million ordinary shares in Sub Co in order to fund a new transaction to be undertaken through Sub Co, being the acquisition of redeemable preference shares that are to be issued from a related party entity.*

35. *Sydney Head Office advanced £20,000,000 to the London PE by way of an intra-bank loan to finance the new share subscription.*

36. *The transaction was recommended and approved by the Executive Director of the London PE and two other senior employees of the London-based Financial Products team (the transaction itself was conceived and its structure designed by the London-based Financial Products team). These three individuals are the sole members of the Board of Directors of Sub Co, with meetings of the Board taking place in London. The Directors also dealt exclusively with the counterparty to the transaction.*

37. *The Board of Sub Co resolved to request the Executive Director at the London PE to increase Sub Co's share capital from £10 to £20,000,010 by the creation of 20 million £1 ordinary shares. The Board then resolved to issue those shares to Bank Co. The subscription by Bank Co was conditional on an undertaking by Sub Co that the funds provided would be used to subscribe for the redeemable preference shares referred to above. Sub Co subsequently acquired those shares.*

38. *Sydney based approvers included the CEO of Bank Co and the head of the Financial Products division, who are both located in Sydney Head Office.*

39. *In January 2015 the redeemable preference shares held by Sub Co were redeemed, with the steps involved in the unwinding of the transaction being coordinated and executed by employees from the London-based Financial Products team. Most of the proceeds from the redemption were redeployed, after approval from the Board of Sub Co, towards a new subscription of redeemable preference shares issued by the same related party entity. The remainder of the proceeds were placed on deposit at the London PE.*

40. *The acquisition of the shares in Sub Co was an activity carried out at the PE. The significant people functions pertinent to the creation and management of the new shares in Sub Co were carried out by personnel located at the London PE. Accordingly, economic ownership of the shares in Sub Co is considered to belong to the London PE. This conclusion is consistent with the accounts of the London PE, and is not altered by the fact that overall approval for the transaction was required to be given by Sydney Head Office.⁴*

Commissioner of Taxation

24 January 2018

⁴ Note that paragraph 10 of Part II of the OECD's 2010 *Report on the attribution of profits to permanent establishments* provides that the centralised management of risk does not generally constitute a key entrepreneurial risk-taking function in the creation or subsequent management of a financial asset.

References

Legislative references	ITAA 1997 ITAA 1997 Div 820 ITAA 1997 Subdiv 820-D ITAA 1997 820-300 ITAA 1997 820-300(1) ITAA 1997 820-300(3) ITAA 1997 820-300(3)(a) ITAA 1997 820-300(3)(b) ITAA 1997 820-395(1) ITAA 1997 820-405
Related rulings/determinations	TR 2005/11
Other references	Model Tax Convention on Income and on Capital 2014 (Full Version) (OECD) 2010 Report on the Attribution of Profits to Permanent Establishments 2010 (OECD)
ATO references	1-BHGA82S
BSL	PGI

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