

***TD 2002/28 - 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 changed over time. This is a consolidated version of the ruling which was published on *18 December 2002*



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## Taxation Determination

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### **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*

*The number, subject heading, date of effect and paragraphs 1 to 10 of this Taxation Determination are a 'public ruling' for the purposes of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner. The remainder of the Determination is administratively binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain how a Determination is legally or administratively binding.*

#### *Date of effect*

*This Determination applies both before and after its date of issue. However, this Determination 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 the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).*

1. This determination applies to income years commencing after 30 June 1994 and up to, but not including, the first income year commencing after 1<sup>st</sup> 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).<sup>1</sup>
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 the foreign bank must apply Part IIIB in its entirety. For example, the foreign bank must reduce any allowable

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

deduction for interest incurred by the Australian branch by the *notional equity requirement* (calculated under subsection 160ZZZB(2)).<sup>2</sup>

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 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.<sup>3</sup> In this respect it is important to recognise that an independent enterprise operating a banking business would usually be required to have equity capital.<sup>4</sup> The amount of equity capital allocated should be determined by taking into account the functions undertaken, assets used and risks assumed by the Australian branch. For example, if the only function of the Australian branch was to invest in risk-free assets, then the amount of capital that an arm's length bank was required to hold against those assets would be virtually zero.

6. The allocation of equity capital under a DTA is the amount that, on the basis of the facts and circumstances of the branch, produces an outcome consistent with the arm's length principle. For this purpose, the Commissioner will accept an allocation of equity capital equal to the amount of capital that would have been required by the *notional equity requirement* calculated under subsection 160ZZZB(2) of Part IIIB. That is, even if on the facts and circumstances it is arguable that a higher allocation of equity capital than the *notional equity requirement* is appropriate, the Commissioner will not require a higher amount of capital.

7. Further, in determining the taxable income of the Australian branch under the DTA, the provisions of Division 16F of the ITAA 1936 dealing with thin capitalisation are also relevant. In relation to foreign bank branches, Division 16F provides the code for dealing with the debt/equity funding from third parties including non-resident associates of the foreign bank. To the extent that Division 16F applies to such funding, it limits Australia's DTA taxing rights in respect of thin capitalisation. Conversely, Division 16F does not apply to intra-bank dealings between the Australian branch and other parts of the foreign bank, as these transactions were never intended to be covered by the Division. Therefore, Division 16F constitutes no restraint of Australia's DTA taxing rights in respect of thin capitalisation of intra-bank funding. In other words, if the outcome under Division 16F is more favourable with respect to borrowings from other persons than would be the position under the DTA, the taxpayer is entitled to the benefit of that more favourable outcome. For example, if an Australian branch of a foreign bank were financed entirely by borrowings from unrelated third parties, interest deductions would not be decreased under Division 16F which disallows deductions only on borrowings from non-resident associates.

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<sup>2</sup> Section 160ZZZB was repealed with effect from 1 July 2001 but continues to apply to certain amounts of interest paid to and derived by a foreign bank during an income year that began before 1 July 2001.

<sup>3</sup> 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).

<sup>4</sup> 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. See also paragraph 3.45 of Taxation Ruling TR 2001/11.

8. Accordingly, where the Australian branch is funded either wholly or partly by intra-bank funds from its head-office or other parts of the foreign bank, the bank should take into account an appropriate amount of equity capital in calculating the deductible interest of the Australian branch. As a result it would not be acceptable for the Australian branch of the foreign bank to have zero capital unless the branch's only business was to invest in risk-free assets, or it was totally funded by loans from third parties.

9. If the Australian branch of a foreign bank has elected to determine its taxable income under the *Business Profits* Article of the applicable DTA, and has not allocated capital in accordance with the arm's length principle in respect to its intra-bank funding, the Commissioner may disallow interest deductions to the extent necessary to produce an outcome consistent with the arm's length principle. However, the amount of interest expense subject to disallowance will be apportioned between intra-bank interest that is not dealt with by Division 16F, and third-party and related-party interest that is covered by Division 16F. For example, if the capital of the branch consists entirely of loan capital with two thirds from head office and one third from unrelated third parties, deductions on the intra-bank loans would be reduced as necessary based on two thirds of the appropriate equity capital in the circumstances under the DTA arm's length test. No deductions would be disallowed under Division 16F on the third party debt as the lenders are not associates of the bank.

10. In circumstances where the DTA operating in combination with Division 16F as explained in the previous paragraph 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.

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## **Commissioner of Taxation**

18 December 2002

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*Previous draft:*

Previously released as TD 2002/D6

- ITAA 1936 Division 16F
- TAA 1953 Part IVAAA

*Related Rulings/Determinations:*

TR 92/1; TR 92/20; TR 97/16; TR 2001/11

*Subject references:*

- Australian branches of foreign banks
- Business Profits Article
- capital allocation
- double tax agreements
- foreign banks
- notional equity requirement
- thin capitalisation

*Legislative references:*

- ITAA 1936 Part IIIB
- ITAA 1936 160ZZVB(2)
- ITAA 1936 160ZZZB(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.
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ATO References

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