TR 2000/D15 - Income tax: application of Division 13 of Part III and double tax agreements to permanent establishments

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Draft Taxation Ruling

Income tax: application of Division 13 of Part III and double tax agreements to permanent establishments

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Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

1. This Ruling deals with:

   (a) the application of Division 13 of Part III of the *Income Tax Assessment Act 1936* ('ITAA 1936') in determining the income and expenditure of permanent establishments ('PEs'); and

   (b) the attribution of profits to PEs under Australia's double tax agreements (DTAs) which are schedules to the *International Tax Agreements Act 1953* ('Agreements Act').

2. The specific provisions analysed are subsections 136AE(4) to (7) in Division 13[1] and the business profits articles in DTAs (usually Article 7 in Australia's recent DTAs).[2] Together these provisions are referred to as Australia's PE attribution rules.

3. This Ruling focuses on attribution issues where the relevant parts of a multinational enterprise (MNE) are structured as a single legal entity carrying on business operations through a PE. The results and methodologies involved are similar to cases applying Australia's transfer pricing rules to international dealings between separate but associated legal entities which have been analysed in Taxation

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[1] FN - All legislative references in this Ruling are to the *Income Tax Assessment Act 1936* unless otherwise specified.

[2] The business profits article varies in a number of respects among Australia's DTAs. This Ruling will generally consider the most recent versions of which the Vietnamese agreement may be considered typical.

Rulings TR 94/14, TR 97/20 and TR 98/11. There are, however, differences between the two groups of rules that may produce different outcomes in the PE setting.

4. The OECD has provided guidance on the matters covered in the Ruling in its 1994 Report entitled *Attribution of Income to Permanent Establishments* and the commentary on Article 7 in the OECD *Model Tax Convention on Income and on Capital*. Currently, the Steering Group on the OECD Transfer Pricing Guidelines is developing further guidelines on the application of the principles in the OECD Guidelines to PEs. This Ruling follows the guidance from the OECD except:

(a) where special provisions in Australia's DTAs and domestic law require or permit Australia to take a different approach; and

(b) where there is no agreement at the OECD on all details for the attribution of profits to a PE.

5. In considering the taxation of PEs, this Ruling takes the following approach:

(a) The arm's length principle provides the economic foundation for taxation of PEs and the interpretation must be consistent with that principle as embodied in Australian law. The operation of the arm's length principle is explained in Taxation Rulings TR 94/14, TR 97/20 and TR 98/11 in relation to separate legal entities.

(b) To the extent that this Ruling goes beyond topics covered in the major transfer pricing rulings released to date, it should provide a basis for a consistent treatment of these matters in the associated enterprises case.

(c) The principles contained in this Ruling are applicable to all dealings where the taxpayer has a PE, either in Australia or overseas.

6. This Ruling does not discuss in detail whether a PE is in existence.

Date of effect

7. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to

the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling.[3]

8. As there has been a progressive development of the approaches outlined in this Ruling and as these approaches are only intended as a guide, the fact that a taxpayer has not applied them is not critical provided the result is consistent with Australia's PE attribution rules. Having regard to the recommendations of the Ralph Committee[4], further developments (possibly including legislation) may be expected.

Detailed contents list

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[3] Refer paragraphs 21 and 22 of Taxation Ruling TR 92/20

[4] Review of Business Taxation (J.T.Ralph Chairman), *Report: A Tax System Redesigned*, July 1999.

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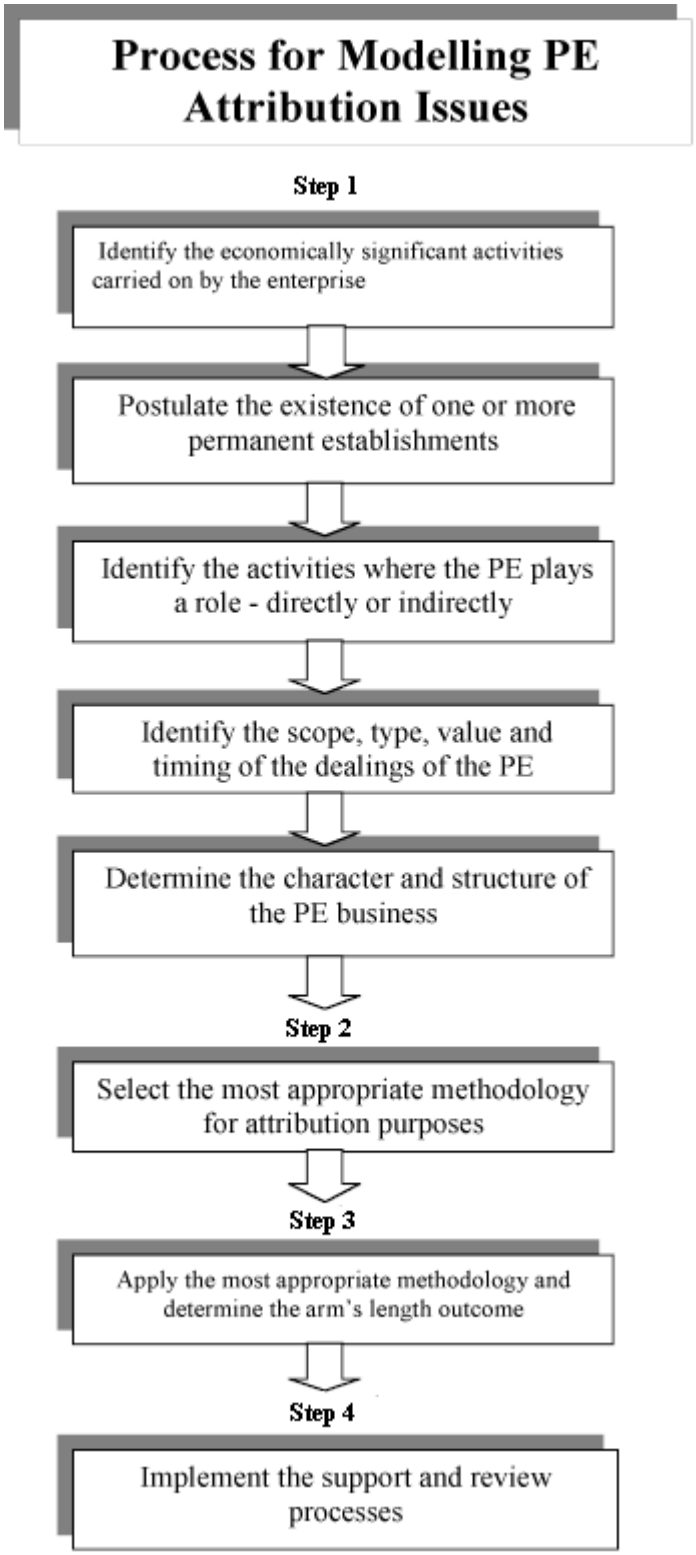
Ruling and explanation

Chapter 1 The nature of PEs and principles of taxation

1.1 So far as is presently relevant, the basic definition of a PE is a fixed place of business of the enterprise through which the business of the enterprise is wholly or partly carried on (see subsection 6(1) definition as modified and extended by subsection 6(1AA) and the Vietnamese agreement Article 5(1)) where each place of business in a country may constitute a separate PE. PEs arise in many areas of international business. Examples of PEs may be found in the following sectors; agriculture, banking, financial services, professional services, education, insurance, construction and development, research and development, mining and exploration, travel services, exporter/importer distributors, transportation, entertainment and e-commerce.

1.2 In working through the treatment of a PE, an adaptation of the four steps set out in Taxation Ruling TR 98/11 is proposed, leading to an economic model of the PE. In this adaptation, Step 1 (to accurately characterise the international dealings where a PE might arise) of the four steps is broken down into five separate activities, reflecting the specific complexities arising in the analysis of a PE. The remaining three steps of the Taxation Ruling TR 98/11 process then follow, also with some specific adaptations appropriate to cope with the PE context. Sometimes the full analysis suggested in Step 1 may not be needed, as the outcomes are obvious, e.g., where the existence of a PE has been accepted by the tax authorities concerned in both the country of the PE and in the country of the enterprise of which the PE is part.

1.3 A process for modelling attribution for PEs is set out in the table below:



1.4 The process suggested here as a guide is essentially iterative, like the four steps.[5] The boundaries of the PE may or may not be obvious and may involve aggregation over time of dealings before acceptable boundaries can be determined and the economic analysis proceeds. Similarly, the comparability analysis[6] may lead to a reconsideration of the boundaries of the PE. For these and similar reasons the five components of Step 1 outlined below (Step 1.1 to Step 1.5), together with Step 2 and Step 3, may need to be revisited until it is clear whether or not a PE exists, and if so, that an appropriate PE has been constructed and a sufficiently reliable economic model formulated from which the income and expenditure of the PE can be determined.

1.5 The relevant economic linkages of an enterprise with one or more PEs may be vertical (e.g., upstream or downstream of the immediate head office) or horizontal, sequential or simultaneous, interactive or independent. Experience suggests that few examples of the manufacturer (head office) - distributor (PE) now occur in practice, being replaced by more complex, networked structures. Examples of the latter may be found in the global trading of financial products and services, where the PE relationships may range from integrated, sequential 24-hour trading through a global network of PEs, to PEs that collect and feed information to centralised product managers, to PEs that trade on their own account as separate businesses.

Step 1.1: Identify the economically significant activities carried out by the enterprise in the relevant countries.

1.6 This Step is closely linked with the preliminary functional analysis envisaged in Step 1 in Taxation Ruling TR 98/11. An important point of difference however is that now the functional analysis from the outset is concerned with the enterprise as a whole, of which the potential PE is a part. It will be important to review the circumstances under which the PE relationship emerged, the way in which relationships developed over time, to identify the economically significant activities[7] in which the potential PE plays a role, including the flows of information associated with these activities, and the assets (tangible and intangible) used and risks assumed by the PE. In particular, attention should be paid to the discretion afforded the management of the potential PE to act independently in such matters as the storage, display or delivery of goods or merchandise, to conclude contracts on behalf of the enterprise and to run the local operation.

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5 See Taxation Ruling TR 98/11 paragraphs 5.1 to 5.16
6 See Taxation Ruling TR 97/20 paragraph 2.32
7 See Taxation Ruling TR 98/11 paragraphs 5.48 to 5.51

1.7 In undertaking a functional analysis it may be helpful to consider the implications of three distinctive patterns in the way value is created by enterprises:

- Creating value through the *transformation* of inputs into outputs;
- Creating value through *knowledge based problem solving*; and
- Creating value through access to and the utilisation of *networked resources*.

1.8 The first pattern includes most manufacturing enterprises where value creation is sequential. The second delivers value by mobilising knowledge based resources and focussing the activities of the enterprise so as to solve unique customer problems, often in an iterative manner. Professional service firms, resource exploration firms, research and development firms, hospitals and educational enterprises are examples. The third delivers value by facilitating network relationships among customers using a mediating technology. Examples include telecommunication companies, transport, insurance and banks. In some enterprises more than one of the three patterns may be found.

1.9 In each pattern, the primary activities may differ:

- In the first, where adding value through the transformation of inputs is central, the primary activities may include inbound logistics, operations, outbound logistics, marketing and service.
- In the second, where problem solving is central, the primary activities may include problem finding and definition, problem solving, choice of action, execution of a chosen solution and control.
- In the third, where network access holds the key, the primary activities may include network promotion and contract management, provision of services to customers, and infrastructure operations.

Common to all three patterns are generic support activities, including development and maintenance of customer relations, human resource management, technology development, procurement and the infrastructure of the enterprise.

1.10 The significant activities that need to be identified in a functional analysis will depend on the ways value is created in the enterprise, and the role the PE plays in these processes. Traditionally, it has often been assumed that value is generated sequentially through the transformation of inputs into outputs. However, it is now increasingly common to find value being generated through problem

solving skills or through access to networks. Where problem solving is involved, the value generating process is often interactive or cyclical in nature, as the enterprise seeks to understand and resolve the clients' problems. Where networks are involved, value creation is often simultaneous or reciprocal, as customers interact in the network environment. These differences may play an important part in the choice of methodology, and may lead to greater use of profit approaches for the problem solving or networked resource patterns due to the generally more integrated nature of the business.

Step 1.2: Postulate the existence of the relevant PE.

1.11 If the arm's length principle is to be applied, it is necessary to 'postulate' the PE as a hypothetical enterprise that is distinct and separate from the enterprise of which it is actually a part.

1.12 Each place of business in a country may constitute a separate PE. However, for the purpose of determining the attribution of income and expenditure of an enterprise in a country, the separate places of business may be aggregated if carrying on the same kinds of activities. On the other hand, it may be appropriate to define more than one PE if clearly differentiated functional activities are found because the analysis may be different in relation to each PE. It may also be appropriate to identify the time period(s) in which the PE is postulated to exist.

Step 1.3: Identify where the economically significant activities are carried out and allocate these where appropriate to the postulated PE.

1.13 In this Step the focus is on which of the economically significant activities of the enterprise are associated with the postulated PE. The activities considered here will flow from the specification of activities and the characteristics of the PE inherent in Step 1.1 above and will reflect the relevant ways in which value is created.

1.14 For each economically significant activity, a determination must be made as to whether or not it is performed within the postulated PE or is performed jointly by the PE and the rest of the enterprise. In this determination, specific attention should be given to the different levels of the decision making process and where the decisions are undertaken with respect to each activity.

1.15 For each activity where the PE participates in the decision making process it is necessary to identify the assets used (both tangible and intangible) and the risks assumed. In addition, it may be necessary to identify the liabilities and capital that are attributable to

funding those assets and covering risks. On the assumption that a PE exists, it is the assets used (not owned) that matter, and the risks that are assumed, implicitly or explicitly, that have to be considered.

1.16 This is an area where the differing legal natures of a PE and a subsidiary may have an effect. Although it is necessary as a part of a functional analysis to specify assets used and risks assumed by the PE, legally the head office usually shares in the assets and risks because it is part, with the PE, of one legal entity. How this legal difference affects the economic modelling will depend on the circumstances.

1.17 When determining which assets owned by an entity are used by a PE, it may be appropriate to establish when the asset was acquired by the entity, where it has been located, over what periods and in what circumstances it has contributed to income or profit or has been idle. Where a PE uses an asset from the time of its acquisition by the entity, the PE will be treated as an economic owner of the asset while that use continues. In relation to most physical assets, the use will be exclusive. In relation to other assets, notably intangible property such as know-how, concurrent use by geographically separate parts of the entity is often possible without any individual loss of enjoyment. In these cases the PE and the other part of the entity are in effect joint owners. Holding an asset that does not currently contribute to income or profit is not regarded as 'use' in this context. Generally speaking, the holding of an idle asset is not an economically significant activity and no reward will be attributable for such holding when the asset, at an earlier or a later point in time, is used by another part of the entity and produces income or profit.[8]

1.18 Under the above approach, there is no intra-entity dealing between the PE and the rest of the entity in relation to an asset when an idle asset is brought into use in the PE activities or there is a change in use (e.g., a productive asset is moved from a head office to the PE).[9] In a start-up situation, a head office is not treated as if it had transferred the asset by way of sale, cost contribution arrangement or lease to the PE on its establishment.

1.19 In relation to risks assumed, the usual situation is for risk to be a factor of the activities carried on. For instance, the risk of environmental damage is a risk commonly associated with mining, the risk of having to meet margin calls is inherent to trading in securities with borrowed money, the risk of personal injuries and property damage is present in many activities such as construction, transport, and manufacturing. In appraising the economically significant activities of a PE, the risks inherent in the activities carried on at the PE should be regarded as risks borne by the PE, whether they be a

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8 In relation to depreciation of plant refer paragraphs 6.25 to 6.29 below.

9 See also Chapter 6 – 'Asset allocations and capital allowances'

likely or unlikely occurrence or potentially have major or minor financial consequences.

1.20 However, in some circumstances, because of the nature of the functions at the PE and head office and the relationships between the activities at each place, some risks may be shared. Where the PE and head office interact as joint venturers carrying out a single economic function it will be appropriate to treat the risks assumed in a consistent way. Another example may be where the operations at each place are arranged so that the financial consequence of a risk is hedged. In such circumstances, the economically significant activities will include both up-side and down-side of the risk and the hedge. In effect the PE and head office are jointly bearing the financial outcomes of events.

1.21 In the PE context the question arises whether the fact that recourse to all the assets of the entity is available for meeting the costs of a materialised risk means that risks, and in particular the risks of catastrophic events, are necessarily shared regardless of the location of the functions to which they may be related. As noted at paragraph 24 above, legally the answer is 'yes'. However, for attribution purposes it will not normally be a material consideration. The operative assumption is that the PE and head office are separate and dealing at arm's length, meaning that the PE would not be expected to bear the consequences of risk associated with head office functions and vice versa. Nonetheless, in some businesses there may be strategies and associated costs incurred at the entity level to protect its assets from catastrophic events, e.g., hedging,[10] enhanced internal audit functions to detect and minimise fraud, additional insurance cover, etc. Where these kinds of strategies are present it is accepted that the economically significant activities of the PE and head office will include the sharing of some aspects of the entity's risks that are not directly related to their particular functions.

Step 1.4: Identify the scope, type, value and timing of the international dealings arising between the PE and the other parts of the enterprise.

1.22 If the PE maintains separate accounts, it may be necessary to adopt some convention as to the way intra-enterprise dealings are incorporated in the accounts, depending on factors such as company law and accounting rules of the jurisdiction where the accounts are prepared, and management policies in relation to the PE. It may also be necessary to decide whether the transactions and dealings reflected in the PE accounts are to be accepted as a true reflection of the economic activity. Moreover, it will be necessary in some cases in building an economic model of the PE to create accounts where none exist or to adjust existing accounts in order to reflect in each case the

[10] See paragraph 1.20

application of the arm's length principle to the postulated separate enterprise.[11]

Step 1.5: Based on a factual understanding of the postulated PE, identify the most appropriate structural analogue(s) to use as a basis for a comparability analysis and in determining taxable income.

1.23 This step links the PE analysis to the analysis relating to associated enterprises embodied in existing rulings. Where the parties involved are legally distinct entities, the comparability analysis needed to establish the arm's length character of dealings between associated enterprises has regard to the characteristics of the products or services; a functional analysis of the functions, assets and risks involved; contractual terms; business strategies and the economic and market circumstances.[12]

1.24 Where the above analysis is concerned with dealings within a single legal entity, as is the case with a PE, it is necessary to proceed by analogy and to look for parallel situations in dealings as if the enterprise and the PE were separate legal entities. Contractual terms and business strategy must be deduced from conduct and an understanding of the economics of the relationships involved in the dealings. Based on this understanding of the PE relationship, the final step in the construction of an economic model of the PE is to identify one or more close structural analogues involving separate legal entities for which appropriate arm's length methodologies exist and to use these analogues in determining taxable income.

1.25 Some relevant structural analogues include:

- Agency relationship
- Contract manufacturing
- Service provider
- Cost contribution arrangements
- Joint venture
- Royalty/licensee/franchisee arrangements
- Manufacturer - distributor relationship

1.26 Steps 2, 3 and 4 as outlined in Taxation Ruling TR 98/11 now follow with changes as needed to adapt to the PE context.[13]

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11 Refer Chapter 5
12 See Taxation Ruling TR 97/20 paragraphs 2.28
13 See Chapter 5

Chapter 2 The role and structure of Australia's PE attribution rules

Attribution rules under Income Tax Assessment Act ('ITAA')[14]

2.1 Subsections 136AE(4), (5) and (6) are three parallel provisions dealing with the calculation of taxable income where a PE is involved. The basic principle is contained in subsection 136AE(4), and the later subsections apply it to partnerships and trusts. Because the operative parts of the three subsections are all to the same general effect, this Ruling is generally expressed in terms of subsection (4). Subject to any specific differences in the wording of the subsections, the views expressed on subsection (4) in this Ruling will, in general, apply also to subsections (5) and (6). Subsection 136AE(4) can be applied to both individuals and companies. In practice, cases almost invariably concern companies and the Ruling is therefore expressed in terms of company taxpayers.

2.2 Subsection 136AE(7) sets out the criteria to be considered in applying 136AE(4). The explanatory memorandum to Division 1315 makes clear that it is the second of these criteria in relation to the arm's length principle that is most important to subsection 136AE(4).

2.3 Subsection 136AE(7) also applies to subsections 136AE(1), (2) and (3), which address the source of income and allocation of deductions in cases involving transactions between separate companies. This aspect of subsection 136AE(7) is discussed in Taxation Ruling TR 94/14.[16] As there are a number of common features between subsections 136AE(1) to (3) and subsections 136AE(4) to (6), the discussion in Taxation Ruling TR 94/14 paragraphs 412 to 419 also has relevance for this Ruling.

Income Tax Assessment Act

2.4 In Australia, the general principles for calculating the taxable income of a taxpayer under the *Income Tax Assessment Act* do not have regard to whether the taxpayer has a branch or activity which constitutes a PE. A resident is assessable on worldwide ordinary and statutory income and a non-resident is taxable on ordinary and statutory income with a source in Australia (sections 6-5 and 6-10 of the ITAA 1997).[17] Most deduction provisions require some

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14 The *Income Tax Assessment Act 1997* (ITAA 1997) and the *Income Tax Assessment Act 1936* (ITAA 1936).

15 Explanatory Memorandum to Income Tax Assessment Amendment Bill 1982, p.73

16 Paragraphs. 418, 419.

17 In the case of capital gains the relevant concept for non-residents is not source as such but whether there is the necessary connection with Australia under Division 136 which is why sections 6-5 and 6-10 also refer to a non-resident

relationship to assessable income, for example, general deductions under section 8-1, and depreciation deductions under section 42-15 (ITAA 1997). Deductions relating to interest expenses are claimable under the general deduction provision section 8-1 (ITAA 1997) but may be subject to certain limitations such as those contained in Division 16F (thin capitalisation) or section 79D (deductions incurred in earning foreign source income).

2.5 Apart from DTAs, the source of income is generally determined under common law rules that have developed over many years. There are a few statutory source rules for specific kinds of income, most of which are only applied to the taxation of non-residents, for example, section 6CA in relation to natural resource income. Most of Australia's DTAs contain sourcing rules which depend on the allocation of taxing rights under the treaty and override the case law and other statutory source rules to the extent of any inconsistency.[18] In the case of a resident company, the source rules are relevant (among other things) to the foreign tax credit under section 160AF and the foreign branch exemption under section 23AH.

2.6 In determining the taxable income of a resident, it is not generally necessary to allocate deductions as between income sourced in Australia and income sourced elsewhere for the purpose of ensuring that deductions relating to assessable foreign income do not reduce Australian source income. It is necessary, however, to allocate deductions of a resident to quarantine foreign losses[19] and for other tax purposes such as determining the foreign tax credit of a resident[20] or the exemption of foreign branch profits of Australian companies.[21] In determining the taxable income of a non-resident, it is often necessary to allocate deductions between income sourced in Australia and income sourced elsewhere because only the former income is assessable. In most cases, there is no detailed guidance in the legislation on the allocation of deductions between income sourced in Australia and elsewhere and the matter has largely been determined on the basis of case law.[22]

Allocation of income and expenditure

2.7 Subsection 136AE(4) introduces the PE concept in the sourcing of income and allocation of expenditure.

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being taxable on amounts which do not have a source in Australia, see EM to the 1997 Act, p.41.

18 See Article 22 in the Vietnamese agreement and subsection 4(2) of the *International Tax Agreements Act 1953*.

19 Section 79D

20 Section 160AF

21 Section 23AH

22 See *Ronpibon Tin NL* (1949) 78 CLR 47; Ruling IT 2446.

2.8 On the source side, judicial decisions have often not accepted artificial tax planning designed to affect the source of income as effective (for example, *Thorpe Nominees Pty Ltd v FC of T*[23]) but have accepted such planning in some cases (for example, *Spotless Services Ltd v anor FC of T*[24]). Subsection 136AE(4) may be used in appropriate cases to ensure that such tax planning relating to source is unsuccessful, and similarly for the allocation of deductions.[25]

2.9 It must be emphasised, however, that subsection 136AE(4) is not premised on any tax avoidance purpose; it may be applied in any case where its terms are satisfied.[26]

2.10 The internationally agreed standard to be applied in determining whether Australia has received its fair share of tax in a case involving PEs is reflected in paragraph 136AE(7)(b) (and the business profits article of all of Australia's comprehensive DTAs[27]). That is, the taxable income (and other relevant tax outcomes) of PEs are generally to be consistent with the treatment of the PE as a separate enterprise from the rest of the enterprise and dealing with the rest of the enterprise on arm's length terms.

2.11 Subsection 136AE(4) deals with the sourcing of income and allocation of deductions of a single taxpayer as between Australia and elsewhere if there is a PE of an Australian resident in another country or a PE of a non-resident in Australia. Such sourcing and allocation are to have regard to the separate enterprise arm's length principle under paragraph 136AE(7)(b), that is, produce the same tax outcome to the extent possible given the different nature of the situation to a dealing between separate taxpayers at arm's length.

2.12 The critical difference between section 136AD which deals with separate entities and subsection 136AE(4) is that the latter takes income and expenditure as calculated under other provisions of the ITAA as given, and by appropriate sourcing of that income or allocation of that expenditure aims to produce outcomes that accord with the separate enterprise and arm's length principle. It does not create income or expenditure but takes them as given from the rest of the ITAA. On the other hand, the deemed arm's length consideration under section 136AD can give rise to income or expenditure that would not arise under other provisions of the tax legislation. In other

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23 88 ATC 4886; 19 ATR 1834

24 96 ATC 5201; 32 ATR 309 (Full Federal Court; an appeal to the High Court of Australia was allowed on other grounds).

25 In appropriate tax avoidance cases, tax planning in relation to the source of income and the allocation of deductions may be dealt with under the general anti-avoidance rule in Part IVA as was the case in *Spotless Services.*

26 Taxation Ruling TR 94/14, paragraphs 401 – 409.

27 See paragraph 2 of Article 7 of the Vietnamese agreement.

words, subsection 136AE(4) applies the arm's length principle indirectly while section 136AD applies it directly.

2.13 The specific language of subsection 136AE(4) centres on the phrases 'income derived by the taxpayer' and 'expenditure incurred by the taxpayer'. Such amounts to which a question of source arises and in respect of which the Commissioner may make a determination are clearly references to the actual income and expenditure of the taxpayer under Australian law not an amount of notional or deemed income or expenditure.

2.14 The only case in Australia which squarely raises this issue is *Max Factor and Co. V FC of T*[28] which supports the view that 'transactions' between head office and PE are disregarded. There, a United States company with a PE in Australia incurred a currency fluctuation loss in transferring funds from Australia to United States. The funds were reimbursement for the cost of raw materials provided by head office to the PE. While internally the funds were treated as payment for the cost of purchases, it was held that they were really a repatriation of capital as there was no legal liability to be discharged. As a result, the currency fluctuation loss claimed as a deduction was disallowed.

2.15 Where there is no income or expenditure recognised under Australia's tax legislation, because of, for instance, a rollover, there is no basis on which subsection 136AE(4) can operate.

Attribution rules under Double Tax Agreements

2.16 In DTAs, the PE concept is central in limiting the right of one treaty country to tax a resident of the other treaty country on business profits. This is to be contrasted to Australian domestic law where jurisdiction to tax depends on residence and source and the PE concept is only relevant at other stages of the taxing process (such as making adjustments under subsection 136AE(4) or exemption of foreign branch profits under section 23AH).

2.17 Further, the purpose of the rules about taxation of business profits under tax treaties is different to the purpose of Division 13. The tax treaties serve to divide tax revenue between countries and to relieve double taxation either by conferring exclusive taxing rights on the residence country in the absence of a PE or profits attributable to a PE, or by requiring the residence country to grant double tax relief where the other country has a taxing right. Division 13 by contrast is designed to ensure that Australia obtains its fair share of tax and only leads to adjustments to increase Australian tax.

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[28] 84 ATC 4060; 15 ATR 231

2.18 The drafting of the provisions also differs. The operation of Division 13 is within the discretion of the Commissioner to make a determination and the arm's length separate enterprise principle is relevant to the exercise of the discretion. Under DTAs, the business profits rules are self-operating ('there shall be attributed') and directly incorporate the arm's length separate enterprise principle as in Article 7(2) of the Vietnamese agreement.

The ATO approach

2.19 Despite the differences in purpose and drafting, the ATO considers that the rules in the DTA are intended to operate through domestic law in the sense that they do not displace the operation of ordinary domestic rules about when income and expenditure are to be recognised for tax purposes. DTAs do not require Australia to depart from its basic approach of allocating actual income and expenditure and do not require us to recognise income or expenditure as being generated through dealings between a head office and PE.

2.20 The OECD Model Double Tax Convention commentary on Article 7 (paragraphs 15 and 28) recognises that the method of operation of domestic tax rules is not displaced by the treaty. Different countries have different domestic rules as to the tax recognition of dealings between head office and PE. In such cases the mutual agreement procedure may be used to resolve double taxation that arises as a result of the differences, regarding the obligation to avoid double taxation as the overriding consideration and not the method of taxation employed. This use of the mutual agreement is to be distinguished from the case where two countries use the same method of taxing but take different views on the correct transfer pricing adjustments.

2.21 This position is supported by the *Max Factor* case referred to above which involved the previous United States convention. The court concluded that the provisions of the tax treaty did not produce the result that the exchange losses of the Australian PE on transfers of funds to the head office were deductible in computing the industrial and commercial profits of the PE.[29]

Alternative approach adopted by some countries

2.22 The words of Article 7(2) of the OECD Model Treaty and Australia's DTAs have been regarded in cases overseas as clear and directive: a separate enterprise is to be hypothesised, transactions

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[29] See also Case 38/95 95 ATC 341, Case 10,267 31 ATR 1027, where the business profits article of current US treaty did not override application of subsection 60(2) on cost for depreciation purposes.

between it and the head office constructed on the basis of its accounts, and the arms length principle applied to those transactions in calculating the PE's profits, notwithstanding domestic law to the contrary.

2.23 For example, in the recent US decision of *National Westminster Bank plc v USA*[30], a UK bank with a branch in the US included interbranch loans in its accounts for tax purposes. Regulation 1.882-5 under the Internal Revenue Code contained detailed provisions for the calculation of interest deductions for branches of foreign corporations doing business in the US. The court held that the regulation was inconsistent with the Business Profits Article of the UK-US tax treaty for two reasons. Firstly, the regulations disregarded all interbranch transactions. Secondly, the regulations provide for interest deductions to be calculated on the basis of a formula rather than determining the interest deductions on the basis of the separate independent operations of the branch. There are also decisions overseas contrary to the *Max Factor* case.[31]

2.24 The ATO does not accept that Australia's tax treaties operate on a strict separate entity basis. Further, there are foreign decisions to the same effect. In *Cudd Pressure Control Inc v The Queen*[32] at first instance the judge held that the business profits article of the Canada US tax treaty did not require that a PE in Canada be treated as having rented equipment from its head office but instead applied the depreciation regime of the domestic law, considering that the treaty could not displace the domestic rules for dealing with the situation which were based on actual expenditure, not notional expenditure. On appeal,[33] the decision was affirmed on the basis of the finding of fact that a PE would not in any event, as a separate enterprise, have leased the equipment. While one judge expressed the view that the business profits article could give rise to deductions for notional expenditure, the other two judges expressly left the issue open. There are also foreign decisions reaching the same conclusion as *Max Factor & Co. v FC of T* in relation to exchange control.

2.25 The Report, '*A Tax* System *Redesigned'*, July 1999, ('the Ralph Report') recommended a progressive introduction in

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30 Court of Federal Claims, 7 July 1999 (1999) US Claims LEXIS 154. See also *North West Life Assurance Co of Canada v Commissioner (1996)* 107 TC 363 where judges of the US Tax Court held by majority that paragraph 842(b) of the Internal Revenue Code which prescribed a method for determining the taxable income of a US PE of a foreign life insurer was overridden by the business profits article of the Canada US tax treaty because the prescribed method was not based on the PE's factual situation and its accounts so far as they present the real facts.

31 See cases referred to in Vogel, K., *Klaus Vogel on double taxation conventions,* 3rd edition, 1997, at page 430

32 95 DTC 559; [1995] 2 CTC 2382.

33 98 DTC 6630.

appropriate circumstances of separate entity treatment in Australia.[34] The Ralph Report also notes that some caution needs to be exercised in this direction where there is no consensus within the OECD.

Chapter 3 The interaction between tax rules that affect PEs

Relationship of subsection 136AE(4) and section 136AD

3.1 Paragraph 136AE(4)(c) prescribes the precondition that none of subsections 136AE(1), (2) or (3) 'applies' to the case in question. This ensures that there is no overlap between the operation of subsections 136AD(1) to (3) and subsections 136AE(4) to (6), in the sense that the same item of income or expenditure cannot be subject to reallocation under both sets of provisions. A precondition to the application of subsections 136AE(1), (2) and (3) is that section 136AD has previously been applied. Paragraph 136AE(4)(c) means that, if section 136AD has been applied to adjust a non-arm's length price between a company of which the PE is a part and another separate entity, the Commissioner may then apply subsection 136AE(1) or 136AE(4) but not both.

3.2 A situation in which subsection 136AE(4) and section 136AD might be applicable to the same item of income or expenditure is where an enterprise carries on business in overseas countries through both branches and related companies. For example, the head office of an Australian resident company manufactures a product at a cost of $50, transports it to a branch in a non-treaty country and records the transfer at cost in its books of account (i.e., $50). The non-treaty country branch in turn sells it to a related Hong Kong resident company for $55. The Hong Kong company sells the product to independent purchasers for $90. Assume that an arm's length price for the dealing between the head office and branch is $80 and for the dealing between the Australian and Hong Kong companies is $85. Section 136AD could be applied to deem the Australian company to have derived $85 from the sale to the Hong Kong company and subsection 136AE(1) then applied to allocate an appropriate portion (approximately $80) to sources in Australia. Alternatively, subsection 136AE(4) could be applied to allocate to sources in Australia the $55 of the income that the Australian company derived from sale of the product. This situation is illustrated below.

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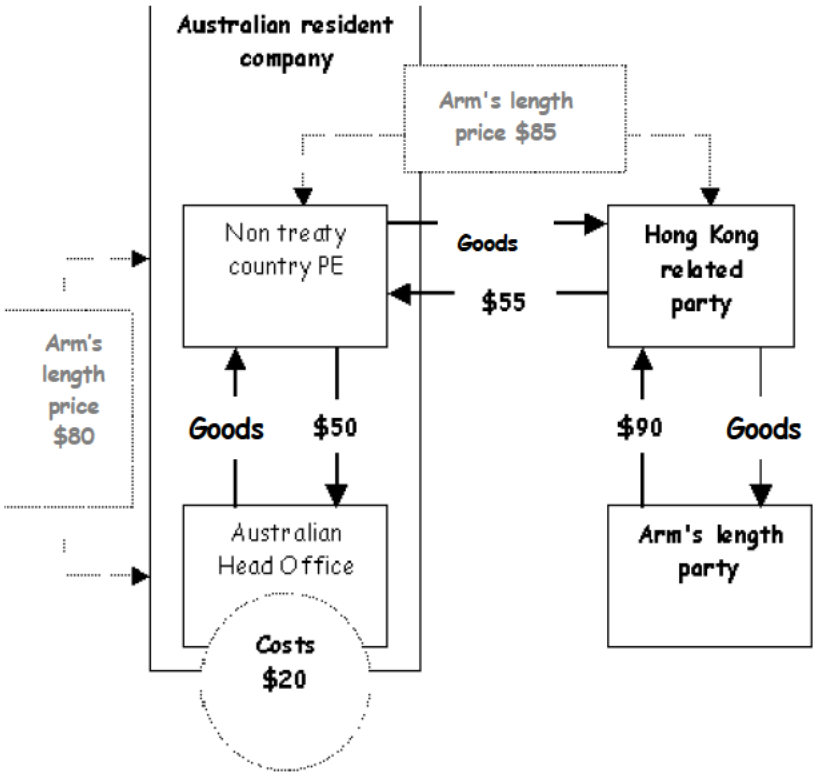
[34] Recommendation 22.11 at pages 668 to 670



3.3 In the above circumstances, the Commissioner would seek to rely on section 136AD and subsection 136AE(1) rather than on subsection 136AE(4), as the application of subsection 136AE(4) would not tackle the real issue, which is the shifting of the non-arm's length profit away from the Australian company to the Hong Kong associate. To the extent that subsection 136AE(1) is applied to deem an Australian source for the relevant income, paragraph 136AE(4)(c) prevents subsection 136AE(4) from applying to that income. The ATO considers that the word 'applies' in this context means that a determination has been made under subsection 136AE(1), not that the case is one where such a determination could be made.[35] Of course, subsection 136AE(4) would be applicable to other source questions arising, e.g., if one were to assume in the above example that the taxpayer in addition to sales of $55 to the Hong Kong related party derived $40 from a Hong Kong unrelated party, the source of that income could be determined under subsection 136AE(4) regardless of the determinations under section 136AD and subsection 136AE(1) with respect to the related party sales.

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[35] See explanatory memorandum to Income Tax Assessment Amendment Bill 1982 paragraphs 4.22 to 4.28.

3.4 The ATO has a choice of powers to address the twin issues of profit allocation and source. It is arguable that in the circumstances described immediately above, that the Commissioner might, by a single determination under subsection 136AE(4), determine the source of the deemed consideration of $85 under section 136AD and the unrelated party sales of $40. However, there is some slight uncertainty whether 'any income' in subsection 136AE(4) includes an amount of deemed consideration under section 136AD and accordingly the better approach is to apply subsection 136AE(1) with respect to the section 136AD amount and then to proceed to make a separate determination to address any separate source issues under subsection 136AE(4).

3.5 If the Commissioner has made a determination under subsection 136AE(4) in relation to a source question, and then becomes aware of the profit shifting issue, the determination does not exclude the making of a determination under section 136AD. However, if such a determination is made following a determination under subsection 136AE(4), it will have the potential to affect the source question under the latter determination. As a matter of practice, the subsection 136AE(4) determination would be revoked before section 136AD is applied and new determinations are made. It is considered that the Commissioner has the necessary power to take this step; it is unlikely that this possibility will arise in practice.

3.6 Another example of a situation to which both section 136AD and subsections 136AE(4) are potentially applicable is where a separate entity constitutes a PE by acting as an agent.

Relationship of subsection 136AE(4) and the rest of Income Tax Assessment Act

3.7 Sections 38 to 43 provide rules for determining taxable income in some circumstances which can overlap with subsection 136AE(4). Unlike the latter subsection, sections 38 to 43 are self-operating and do not depend on the making of a determination by the Commissioner. Subsection 136AE(9) removes any implication that sections 38 to 43 resolve questions of source of income and allocation of deductions so that such a question could not arise in terms of paragraph 136AE(4)(b). Hence, the way is open for a determination under subsection 136AE(4) even in cases where sections 38 to 43 operate.

3.8 If a determination has been made under subsection 136AE(4), section 136AG effectively provides that the determination takes precedence over the operation of sections 38 to 43 and, to the extent that income and deductions are dealt with in a determination, sections 38 to 43 are excluded from operation.

3.9 There are several other provisions in the tax legislation where it is provided in certain circumstances that arm's length prices are substituted for the price used by the parties, for example, section 70-20 in relation to non-arm's length dealings in trading stock. There is generally no conflict between these provisions and subsection 136AE(4). These provisions only apply in cases where there are transactions which give rise to income or expenditure under the tax legislation. As already noted in the PE context, the arm's length price is applied to transfers between head office and PE where there is no relevant transaction for tax purposes and the arm's length price only operates indirectly to effect an allocation of income and expenditure in determining taxable income.

Relationship of subsection 136AE(4) and the business profits article of DTAs

3.10 The business profits articles of DTAs are self-operating and take precedence to the extent that they are inconsistent with the ITAA. In the ATO's view, this means that a determination under subsection 136AE(4) is not necessary where a DTA applies before issuing an amended assessment. For reasons noted below, however, a determination would normally be made.

3.11 The business profits articles in all of Australia's DTAs expressly provide that nothing in the article affects the application of domestic law to determine tax liability in certain circumstances. These circumstances differ between agreements. For most DTAs, the circumstances are where the information available is inadequate to determine the profits attributable to a PE. In other DTAs, the circumstances include exceptional difficulties.

3.12 These provisions mean that the DTAs themselves recognise the application of domestic law, so far as is practicable to do so, consistently with the principles of the business profits articles. Section 136AE does not have a provision equivalent to subsection 136AD(4), which permits a determination in cases of difficulty. This lack does not mean that the DTA provisions just described in the case of PEs are ineffective. Subsection 136AE(4) does not require (like subsections 136AD(1) to (3)) that the arm's length consideration be substituted. Rather, the separate enterprise basis and arm's length principle are matters that go to the exercise of a general discretion and the Commissioner is permitted to consider other matters which are regarded as relevant (paragraph 136AE(7)(c)).

3.13 The matters referred to in the DTAs will be relevant matters for this purpose and so the Commissioner can use a determination under domestic law if the DTA condition for doing so is fulfilled. In such cases, under the treaty as under domestic law, the main consideration in exercising the discretion will be to give effect to the

extent possible to the separate enterprise basis and arm's length principle.

3.14 This type of provision in treaties may lead taxpayers to argue that a DTA case is one which falls within the special paragraph permitting recourse to domestic law and that an amended assessment fails if not supported by a determination under Division 13. For this reason, even in a DTA case, a determination under subsection 136AE(4) can be expected to be made to support an amended assessment.

3.15 In some cases, there may be differences in the scope of the treaty provision and subsection 136AE(4). For example, the broad definition of PE for Division 13 purposes may extend beyond the treaty definition.[36] In other cases, the business profits article may permit the taxation of profits even where profits are not attributable to a PE, while paragraph 136AE(4)(d) requires a connection to the PE; for example, Article 7(1) of the Indonesian agreement permits taxation of profits for goods and services of a similar kind to those provided through the PE.

3.16 In the former case, the result will usually be that the Division 13 power is overridden by the DTA as, in the absence of a PE as defined in the DTA, only the residence country will have power to tax. In the latter case, an adjustment can be made under the treaty in accordance with the separate enterprise and arm's length principle even though there may be no power under Division 13. It will be an unusual case where these kinds of differences between Division 13 and DTAs are relevant.

Business profits and associated enterprises provisions of treaties

3.17 Just as there is an issue of interaction between section 136AD and subsection 136AE(4), so there is a similar question under DTAs for the business profits article and the associated enterprises article. DTAs contain no explicit priority between the two articles. As the business profits article is self-executing while the associated enterprises article is expressed in permissive form, it is considered that the business profits article takes precedence in the sense that it operates automatically. It does not, however, prevent an operation of a further adjustment under the associated enterprises article to the extent that the adjustment under the business profits article falls short of satisfying the arm's length principle with respect to an associated enterprise.

3.18 The various possibilities may be shown by considering variations of the example given above in paragraph 3.2. Assume that

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[36] See paragraphs 4.22 to 4.28 below

the branch of the Australian entity is in a treaty country. On the example as given, Australia would use a section 136AD determination to increase the sale price to the related party to $85. This sale price would then be used for the application of Article 7 as between the head office and PE. An amount of $80 would be treated as Australian source and an amount of $5 sourced in the treaty country (assuming that these represent the relevant arm's length transfer prices).

3.19 If the related party were a resident of the treaty country for the purposes of an agreement with Australia, both Articles 7 and 9 of that DTA would be relevant. Under Article 9 of that DTA, the consideration for the sale to the related party could be adjusted to the arm's length price ($85). This price could then be used to allocate income between the head office and PE in accordance with the arm's length separate enterprise principle of Article 7 as in the previous paragraph. If the related party were resident in another treaty country, the associated enterprises article of that DTA would be applied to adjust the sale price to the related party. Article 7 of the first treaty country DTA would operate as before.

3.20 A related question concerns differences in the way that the business profits article in DTAs is expressed. Most modern treaties include the words 'or with other enterprises with which it deals' at the end of paragraph 2 of the business profits article. This permits adjustment to arm's length principles where the taxpayer of which the PE is a part has dealings with an associated enterprise which are not on an arm's length basis. Although the paragraph does not require that the other enterprise be associated with the taxpayer, this would be the normal case where the issues arises. The other enterprise may not be a resident of the PE state, which is the only case where the power under the associated enterprises could be activated. It is not clear, however, if this is sufficient to adjust the income of the legal entity of which the PE is part to the arm's length price on sale to a related party for the purposes of the allocation of income and expenditure process required by Australian law.

3.21 In these situations, and also where the applicable business profits article does not include these words, section 136AD may be used to adjust for any non-arm's length dealings between the taxpayer and associates ensuring that the taxpayer's business profits for taxation purposes are correct before attribution of profits to the taxpayer's PE in accordance with the article. In effect, section 136AD fills any problem or gap that may exist in treaties.

Relationship between attribution rules under the business profits article and subsection 136AE(4)

3.22 The business profits article, in common with other treaty provisions, incorporates relevant Australian domestic tax law by

operation of the *International Tax Agreements Act 1953*. Thus, it sits alongside the provisions of section 136AE under the legislative framework.[37]

3.23 Potentially, in treaty country PE situations, both the business profits article and subsection 136AE(4) attribution rules may apply. In the event that the outcomes of the application of each are inconsistent, the result under the business profits article prevails.[38]

Relationship with other provisions of the ITAA

3.24 Several other provisions in the tax legislation also deal with the calculation of the taxable income of a PE. The provisions include the foreign bank branch regime in Part IIIB and thin capitalisation in Division 16F.

Chapter 4 Concepts and interpretation of PE attribution rules

Tax result

ITAA

4.1 Under paragraph 136AE(4)(d), it is a condition of application of the provision that a determination under the provision must result in a greater tax result compared with that based upon the tax return lodged.

4.2 The term 'tax result' in this context warrants explanation as the test is to be applied on a wide basis. A tax result is more favourable to the taxpayer if the return furnished would result in less tax in respect of that year or *a different year*. If, on the basis of the return furnished, no tax liability would exist for that year of income, and a determination under subsection 136AE(4) would not result in any more tax for that year, the condition in paragraph 136AE(4)(d) may nevertheless be satisfied. For instance, the tax result would be considered more favourable to a taxpayer if a determination under subsection 136AE(4) would reduce the amount of any loss which, on the basis of the return furnished, would otherwise be carried forward and offset against assessable income of future years. Anything that can affect tax payable is encompassed in the tax result. Hence, it includes tax offsets (such as a foreign tax credit), exempt income (such as for foreign branches) as well as assessable income and allowable deductions.

4.3 If a taxpayer wishes to challenge ATO's actions, recourse to the normal domestic appeal procedures will be necessary. If the taxpayer wishes to change its own allocation of income and

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[37] Refer subsection 4(1) *International Tax Agreements Act 1953*

[38] Refer subsection 4(2) *International Tax Agreements Act 1953.*

expenditure in its original return, it cannot require the ATO to make a determination under section 136AE. It will be necessary to self amend or challenge the original assessment (or deemed assessment) under normal domestic rules as appropriate.

4.4 The condition under paragraph 136AE(4)(d) refers to 'the return furnished by the taxpayer' and assumes that there is such a return. In cases where a taxpayer does not file a return, the ATO has various powers to deal with the taxpayer, including calling for a return under section 162. Further, in the absence of a return, the ATO may make a default assessment under section 167. In these cases, the ATO will, if relevant, seek to apply principles consistent with subsections 136AE(4) and (7).

DTAs

4.5 The business profits provisions of DTAs contain no precondition for their operation depending on the tax result. It would be open to a taxpayer to self-assess on the basis of the application of the business profits article of a DTA. Normally, however, the ATO will not on its own motion amend assessments in cases involving DTAs if the effect is to reduce tax payable. It will be up to the taxpayer to self amend or to challenge the assessment (or deemed assessment) in accordance with Australian law in such cases. If the taxable profits of the taxpayer have been adjusted by the other party to the DTA and the taxpayer wishes the ATO to make a correlative adjustment, they can be guided by the mutual assistance procedures. A Taxation Ruling on these procedures is expected to issue.

Mandatory or discretionary application

ITAA.

4.6 Subsection 136AE(4) is not self-operating; it is clearly discretionary – 'as the Commissioner determines.' It requires a determination of source of income and/or allocation of deductions which will then lead to the amendment of an assessment in relation to one or more income years. If the arm's length separate enterprise principle would produce a materially different outcome to that in the taxpayer's return, the discretion will normally be exercised. As with the application of the arm's length principle to associated enterprises, however, the power will not be used to make marginal adjustments.[39]

4.7 As an exercise of administrative discretion, any challenge to the assessment resulting from the determination will be subject to the usual considerations relating to discretions. As a minimum

[39] See Taxation Ruling TR 97/20 paragraph 1.1

requirement, the decision-maker will need to ensure firstly that each of the preconditions in paragraphs (a) to (e) of subsection 136AE(4) is satisfied. Secondly, it will be necessary to have regard to the matters set out in subsection 136AE(7). Thirdly, in applying these criteria, recourse should be had to information which is sufficient to allow the statutory function to be properly carried out; that is, it can be demonstrated by reference to the relevant facts that an informed and reasonable decision has been made in the circumstances.

DTAs

4.8 The business profits rule in DTAs is self executing. Nevertheless, the differences in practice between the application of domestic provisions and the DTA will be minimal. On the ATO side, an amended assessment will usually be accompanied by a subsection 136AE(4) determination. On the taxpayer's side, it will be necessary to self-assess on the basis of the DTA, self amend or challenge an assessment, or seek correlative adjustments.[40]

Types of taxpayers

ITAA

4.9 Allocation questions may arise in relation to business activities carried on by 'taxpayers' in the ordinary subsection 6(1) meaning of that term (a person deriving income, person in turn being defined to include a company) or in its extended meaning under subsection 136AA(1) which includes a partnership or the trustee of a trust estate. As indicated above, Division 13 provides separate provisions for businesses carried on by partnerships and trusts and taxpayers other than partnerships or trusts. It follows that subsection 136AE(4) is confined to taxpayers other than partnerships and trusts, that is, generally companies and individuals.

4.10 Thus, the Commissioner's power to determine source of income or allocation of expenditure between sources extends to a partnership carrying on business at or through a PE outside Australia. The same applies to a partnership with a PE in Australia so long as one or more partners are resident outside Australia. The provision for businesses carried on by trustees is similarly structured.

DTAs

4.11 The business profits article does not directly specify what kind of entities are subject to the attribution rule. The terminology used

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[40] See above under 'tax result'

concerns an 'enterprise' carrying on a business at or through a PE; and in this context the term 'enterprise' is fairly broad. The word enterprise may cover the entity or the framework through which an activity is carried out. The entity meaning would be the natural construction in the context of the associated enterprises article where one is concerned with an enterprise participating in the management, control or capital of another enterprise. The other construction, which is the one that applies in the context of the business profits article, is that enterprise is the activity carried out, including continuing conduct or isolated transactions entered into for business or commercial purposes.[41]

4.12 The links between the 'enterprise' identified for Article 7 and the 'taxpayer' according to its domestic law meaning are provided by the definitions of 'enterprise of a Contracting State' and 'enterprise of the other Contracting State', 'person' and 'resident'.[42] Essentially, the reference to enterprise in Article 7 is a reference to the taxpayer according to Australian law carrying on the relevant activities.

4.13 The application of DTAs to partnerships is a much debated issue on which the OECD has just released a Report.[43] In the case of general partnerships, the Australian approach is to tax partners on the basis that each partner has a PE where a partnership business has a PE under the DTA. While this is a different basis to that under subsection 136AE(5), the outcome in practice will be the same. In the case of limited partnerships, Australia taxes these as companies and, where appropriate, applies DTAs accordingly where there is a PE in Australia of the limited partnership.

4.14 In the case of trustees, Australia has introduced provisions into the Agreements Act and treaties[44] to clarify the taxation of the beneficiary in the case where the trustee has a PE. Subsection 3(4) of the Agreements Act makes it clear that where a beneficiary is presently entitled to a share of business profits of a trust estate, the beneficiary is deemed to have derived the income. Thus, where profits derived by a trustee on behalf of trust beneficiaries are attributable to an Australian PE, the profits will be income derived by the beneficiaries to the extent of present entitlement.

4.15 Subsection 3(11) of Agreements Act, and equivalent DTA provisions, are designed to ensure that beneficiaries presently entitled to income of business trusts with a PE will be taxable under DTAs on their share of the PE income even though the beneficiaries do not have their own PEs. As a result of these provisions, the outcome is in

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41 *Thiel v FC of T* 90 ATC 4717; 21 ATR 531

42 See Articles 3 and 4 of the Vietnamese agreement

43 OECD, *The Application of the OECD Model Tax Convention to Partnerships*; Issues in International Taxation No.6, 1999.

44 For example, Article 7(8) of the Vietnamese agreement

practice the same as under subsection 136AE(6). Tax reform proposals are that trusts will be taxed in the same way as companies in future. In that event, DTAs will be applied directly to the trustee if there is a PE in Australia.

Residence

ITAA

4.16 Residents and non-residents are referred to separately in paragraph 136AE(4)(a) to make clear that it applies to residents with a foreign PE and non-residents with an Australian PE. The definitions in subsection 6(1) of resident and non-resident apply for this purpose. This definition applies in the case of a resident even if the taxpayer is a dual resident, i.e., resident in Australia under its tax laws and resident in another country under its tax laws.

4.17 In the case of partnerships and trusts, the residence criterion is dealt with differently. If a partnership or trust has a PE in Australia, it is necessary that there be a non-resident partner or beneficiary (subparagraphs 136AE(5)(a)(ii) and (6)(a)(ii)). These provisions then operate in conjunction with the provisions for taxation of foreign partners or beneficiaries (e.g., paragraph 92(1)(b) and subparagraph 97(1)(a)(ii)). If a partnership or trust has a PE outside Australia, there is no reference to a residence criterion (subparagraphs 136AE(5)(a)(i) and (6)(a)(i)). The residence criterion in this case will be generally supplied at the level of the partner or beneficiary by partnership and trust provisions (e.g., subsections 92(1) and 97(1)) in combination with the exemption (subsection 23AH(3)) or credit provisions (section 160AF).

4.18 If the partnership or trustee is taxable and is a non-resident (in the case of partnerships, this can only apply to limited partnerships), the result is that no power exists to adjust the position of the partnership or trust unless there is a non-resident partner or beneficiary. In such cases, other assessing provisions may be relevant to the resident partners or beneficiaries such as the controlled foreign company provisions[45] or the transferor trust provisions.[46]

DTAs

4.19 As already noted, DTAs link the taxation of PEs to the residence of the enterprise. Residence for this purpose is determined under the DTA, which usually contains a tie-breaker for the case of dual residents. It is the treaty residence thus determined in the case of

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[45] Part X, ITAA 1936

[46] Div 6AAA of Part III, ITAA 1936

dual residents that operates in the context of the business profits article. Thus, if a dual resident's residence is allocated by the tie-breaker to the other country, Australia will only be able to tax the business profits attributable to the PE in Australia of the taxpayer (generally if a taxpayer is resident in Australia under domestic law, it will have a PE here under the treaty definition). Australia will not be able to tax the business profits attributable to the other country (of treaty residence) nor the profits attributable to PEs that the taxpayer may have in third countries.

4.20 Although not a treaty resident of Australia, the taxpayer will continue to be a resident under Australian law and will usually have a PE in its other country of residence, as well as possibly third countries under the definition of PE which is operative for the purposes of Division 13. The ATO will continue to have power under subsection 136AE(4) to make a determination of allocation of income and deductions on the basis that there is an Australian resident with a PE outside Australia. However, the determination will relate to Australian source income only because the DTA outcome will prevail. Further, it should be noted that the allocation power under subsection 136AE(4) in relation to a non-resident with a PE in Australia (the treaty situation) is not applicable in this case because the taxpayer will not be a non-resident for the purposes of Division 13.

4.21 If the treaty residence of the taxpayer is allocated under the tie-breaker to Australia, Australia will have power under the treaty to tax all the business profits of the taxpayer. The allocation power under subsection 136AE(4) will apply to deal with the source of Australian and foreign income purposes including foreign loss quarantining, foreign tax credits and exempt income.

Permanent Establishment

4.22 It is not within the intended scope of this Ruling to discuss in any detail the concept of a PE. However it is appropriate to note in passing the source of the applicable definitions and make some general observations. Further, it is important to note the link between the identification of the PE and the effect of the scope of the PE on the calculation of income. The modelling of the PE was referred to in Chapter 1 as a critical part of the first step in applying the arm's length separate enterprise principle. Obviously, such modelling has to be consistent with the relevant definitions. The definitions not only determine if a PE exists but also the bounds of the PE. In modelling the PE, it thus is not possible to go beyond the bounds of the relevant definition.

4.23 In common with the OECD Model Convention and accepted international practice, Australian definitions both extend and limit the basic 'place of business' criterion that is at the heart of the PE

concept. For instance, both DTA and domestic law provisions include dependent agencies, use or installation of substantial equipment, and construction projects and excludes independent agencies, and places where certain limited functions are conducted such as purchasing of merchandise.

ITAA

4.24 The relevant business must be conducted at or through a PE under subsection 136AE(4). 'PE' for Division 13 purposes picks up the section 6(1) definition with an extension under subsection 136AA(1) incorporating 'a place at which any property of the taxpayer is manufactured or processed for the taxpayer, whether by the taxpayer or another person.' The phrase 'at or through' envisages a connection between the business and the PE activities in terms of situs or the other critical factors going to PE status. The word 'at' may be read as 'at the place' in the case of a typical fixed place PE. 'Through' deals with other types of PE and may be read as 'through the agency' or 'through the use of substantial equipment' etc.

4.25 As noted above, section 23AH, which exempts foreign branch, income of a resident from Australian tax on certain conditions is one of the cases where a determination under section 136AE will impact in the case of a resident with a PE outside Australia. For the purposes of section 23AH, the PE definition in subsection 6(1) without the amplification of subsection 136AA(1) applies in a non-treaty case while the treaty PE definition applies in a treaty case.[47]

DTAs

4.26 The concept of a 'PE' for DTA purposes is defined in the 'permanent establishment' article (generally Article 5 as in the Vietnamese agreement).

4.27 The definitions for DTA and section 136AE purposes are similar but not identical. In the vast majority of situations encountered in practice, aspects of the definition will not be a matter of contention as the relevant activities will consist of a readily recognisable branch or other substantial presence where business is conducted. However, this will not always be the case. It will often be important for the application of the attribution rules to decide the status of activities of a more limited, transient or itinerant nature or where they are conducted in the 'source' jurisdiction indirectly, i.e., through some form of agency. In general, it may be said that the DTA definition of PE covers a narrower range of cases than the domestic provision.

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[47] See subsection 23AH(12)

4.28 The details of the DTA PE definitions vary according to the specific terms negotiated between Australia and its treaty countries. The fact that a PE may exist in circumstances that do not involve a branch as such, has implications for the application of the attribution rules. Where the source taxing rights attach to a deemed PE, e.g., supervisory activities, there will not necessarily be accounts separately reporting income and expenditure connected to that activity. Thus, as a starting point for the application of the attribution rules it will be necessary to conduct factual enquires in order to extract relevant financial and other information from the taxpayer's business records for constructing PE income, expenditure and profit.

Attribution

ITAA

4.29 Paragraph 136AE(4)(e) limits the scope of subsection 136AE(4), so that it applies only if, in the Commissioner's opinion, some part of the income or expenditure to which paragraph 136AE(4)(b) refers is attributable to the activities conducted at or through the PE. Paragraph 136AE(4)(e) differs from preceding paragraphs as it requires, and is sufficient, that the Commissioner reach an opinion as to certain facts.

4.30 'Attributable' in this context has the same meaning as under the business profits article. The commentary on the OECD Article 7 states that the approach to the attribution test preferred by most countries focuses on where the profits are generated, that is whether they are generated through the PE. This will be so where, in substance, the resources and activities at the relevant place are the source of the profit.[48]

4.31 An examination of the separate 'sources of profit' (income and expenditure under subsection 136AE(4)) in this context does not revolve around the judicial source rules. For the purposes of paragraph 136AE(4)(e), the Commissioner may properly form the opinion that income or expenditure is attributable in whole or part to a PE on the grounds of commercial and economic reality.

4.32 Accordingly, income is attributable to activities conducted at or through a PE to the extent that those activities are, in substance, a contributing factor in generating the income or give rise to benefits from expenditure incurred.

4.33 By way of illustration, the application of subsection 136AE(4) may be considered in relation to a source question under section 23AH, which exempts from Australian taxation certain foreign branch income derived by a resident company taxpayer. Whether income is

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[48] OECD Commentary, Article 7, p. C(7)-3

'foreign branch income' brings into relevance paragraph (b) of the definition of 'foreign income' in subsection 23AH(12), which in turn refers to 'an amount that is derived from sources in a foreign country'. Where a determination under subsection 136AE(4) has been made, 'foreign branch income' for section 23AH purposes will be the income which the Commissioner has deemed to have been derived from foreign sources, and which satisfies the other conditions for foreign branch income prescribed in section 23AH.

4.34 A determination under subsection 136AE(4) as to whether expenditure is incurred in deriving income from a particular source may apply in determining whether expenditure is deductible or incurred in deriving income that is exempt under a provision such as section 23AH, or in considering the treatment of foreign losses under section 79D, or foreign tax credits under section 160AFD.

4.35 When attributing income and expenditure to the PE regard must also be had to other provisions of the ITAA 1936, including Division 16F (thin capitalisation) and Part IIIB (foreign bank branches).

DTAs

4.36 The attribution issue under subsection 136AE(4) arises as an issue going to the power of the Commissioner to make a determination, that is, it does not directly affect the issue of whether and how Australia taxes the income in question. Under DTAs, attribution has a more fundamental role. Unless the business profits are attributable to a PE, the power to tax is given exclusively to the taxpayer's state of residence.

4.37 It follows that if there is no PE in the other state, that state has no power to tax the business profits (assuming they are not covered by another article of the treaty). Further, if there is a PE there is still no power to tax particular business profits of the enterprise unless they are attributable to the PE. These two propositions are fundamental to the operation of tax treaties.

4.38 Some of Australia's tax treaties[49] deviate from the second proposition and permit taxation in certain limited cases where profits are not attributable to the PE. This limited force of attraction principle is adopted from the United Nations Model Double Taxation Convention.

4.39 There is a variety of language used in tax treaties and domestic law to describe the attribution concept. Articles 10 to 12 and 21 of the Vietnamese agreement and the OECD Model Treaty use the phrase 'effectively connected with'; in the case of Articles 10 to 12 this refers

[49] For example, Article 7, the Indonesian agreement

to the property giving rise to the type of income in question and in Article 21 to the income. Similarly, Article 13 on capital gains refers to property that forms part of the business property of a PE. In the ITAA, subsection 136AE(4) refers to the derivation of income or the incurring of expenditure being attributable to activities carried on by the taxpayer at or through the PE, section 23AH refers to foreign income derived in carrying on a business at or through a PE, and subparagraph 128B(3)(h)(ii) to interest derived by a non-resident in carrying on business in Australia at or through a PE of the non-resident in Australia (similar language occurs elsewhere in section 128B).

4.40 Notwithstanding the variety of expression, it is considered that the same operating idea of attribution applies in these and similar cases. Otherwise there would be discontinuities within treaties and domestic law. For example, if the concepts within Article 7 on the one hand and Articles 10 to 12 on the other were different, the provisions would not fit neatly together as is so obviously intended. While the definition of PE varies between treaties and domestic law, and domestic law may use different methods of taxing particular income compared to treaties, it is considered as already noted that the same underlying concept applies to both.

Source of income and allocation of expenditure

ITAA

4.41 The concept of source is central to the operation of subsection 136AE(4). Under paragraph 136AE(4)(b), one of the alternative conditions is that 'a question arises whether, and if so, to the extent to which' any income derived by the taxpayer is sourced inside or outside Australia. The other alternative relates to expenditure incurred in deriving income sourced inside or outside Australia. If the preconditions to the exercise of power under the provision are fulfilled, any determination by the Commissioner will allocate the income to a source or proportionately to several sources and the expenditure to income from a source or proportionately to income from several sources.

4.42 It is considered that one or both of the alternative preconditions will be satisfied where business activities are conducted at or through a PE because in such circumstances it will be necessary for the purposes of the ITAA to allocate income and expenditure between the PE and other activities. The concept of a question arising does not imply an element of contentiousness (i.e., a dispute between the taxpayer and the Commissioner on how income or expenditure should be allocated between sources) or a lack of certainty as to the source or allocation of expenditure based on general principle. The words 'extent to which' concern apportionment and anticipate

situations where there is a question of allocation of single amounts of income or expenditure.

4.43 A determination of source of income or allocation of expenditure to income under subsection 136AE(4) is 'for all purposes of the application of this Act in relation to the taxpayer'.[50] There is no indication that the power is limited by judicial principles or other statutory provisions as to the source of income or allocation of deductions (apart from DTAs discussed below). Hence, a determination can override the result that would follow under such principles or provisions. Indeed, a major reason for inserting the provision into the Act is to allow the source of income and allocation of expenditure to be aligned by a determination with the arm's length separate enterprise principle in the PE context. This principle is not generally regarded as relevant in judicial principles, nor is it mentioned in other statutory source or allocation rules. Moreover, apportionment of income and expenditure across a number of sources is permitted even where apportionment would not be possible under judicial principles or other statutory provisions.[51]

DTAs

4.44 The OECD Model Treaty does not generally utilise the notion of source in relation to allocation of taxing rights. Rather, it simply specifies the circumstances in which the residence and the other country may tax certain categories of income. Australia's treaties make the link to domestic law by including a provision on the source of income. In modern treaties, this provision generally provides that if the country which is not the residence country of a taxpayer is given the right to tax income, profits or gains of the taxpayer, that income, profit or gain is given a source in that country for the exercise of taxing rights and for relief against double taxation, both under the treaty *and under domestic law*[52]. As DTA provisions prevail over the ITAA (including Division 13, source and allocation rules under judicial principles and other statutory provisions), it follows that source arising under a treaty as a result of this rule cannot be overridden by a determination under subsection 136AE(4).

4.45 In the business profits context, this difference in structure in DTAs will not generally produce different results, for the business profits article determines the profit attributable to a PE by reference to the arm's length separate enterprise principle which allocates both income and expenditure as explained in paragraphs 2.19 to 2.21

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50 See Taxation Ruling TR 94/14 paragraphs 179 to 183 and Taxation Ruling TR 1999/8 paragraph 3 for the meaning of this and similar phrases

51 *Hillsdon Watts Ltd* (1937) 57 CLR 36 at 48, 51-52 on an earlier provision in similar form.

52 For example, Vietnamese agreement, Article 22

above. One difference is that the treaty rule relates only to the profit (which is equated in domestic law to taxable income as discussed below) rather than the revenue and expenditure that goes to make up the profit. This kind of formal difference can also arise under domestic law[53] but has not been regarded as substantively different in effect.

Income and profits

4.46 A variety of terminologies are used in the ITAA and DTAs. The Act has ordinary income, statutory income, assessable income and exempt income among others while the terms income, profits and gains appear in tax treaties. This section describes the relationships between these terms.

ITAA

4.47 The term 'income' is defined for Division 13 purposes in subsection 136AA(1) to include any amount that is, or may be, included in assessable income or taken into account in calculating an amount that is, or may be, included in assessable income. Thus, profits and gains which are not income according to ordinary concepts but are nonetheless assessable as statutory income may be subject to subsection 136AE(4). The definition in subsection 136AA(1) does not define income exhaustively. Income according to ordinary concepts or statutory income which is exempt is considered to also come within the term 'any income' in subsection 136AE(4). Further, revenue which goes into the calculation of a profit which enters assessable income on a net basis is also clearly included.

4.48 Because net capital gains are included in assessable income it is considered that they are also covered by the term 'income'; as indicated above 'income' is defined as any amount included in 'assessable income', which in turn includes 'ordinary income' and 'statutory income'[54]. The latter embraces capital gains.[55] As source is not a concept that is directly relevant to capital gains (which instead uses the concept of a connection with Australia in the case of taxing non-residents), a determination of source under subsection 136AE(4) may not produce any tax consequences under other provisions of the ITAA. There are, however, a number of cases where source of capital gains and therefore section 136AE are relevant. The most important in this context is for the foreign tax credit as a result of subsection 160AE(2) dealing with the source of capital gains. Another issue in

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53 For example compare section 6-5 of ITAA 1997 and sections 38 to 43 of ITAA 1936)

54 Section 6-1 ITAA 1997

55 Section 10-5 ITAA 1997

the capital gains context is that what may be termed domestic and foreign capital gains are netted off against each other before an amount is included in assessable income. Taxation Ruling IT 2562 deals with the interaction of the CGT and the foreign tax credit and provides an ordering of netting in such cases. A determination of source under subsection 136AE(4) will not affect this netting procedure which is applied after source is determined.

4.49 In cases where only a net amount is taxed either as income or capital gain, there is an issue whether the relevant costs are dealt with as part of income (through the extension to include amounts taken into account in computing assessable income) or as expenditure. The ATO considers that such amounts could be accounted for under either head. As already noted above, sourcing of net as opposed to gross amounts is not regarded as producing differences in result.

4.50 The word 'derive' used in conjunction with income in subsection 136AE(4) includes under subsection 136AA(1) 'gain or produce'. Income is not derived, gained or produced and cannot be subject to allocation under subsection 136AE(4) until such time as a crystallising event occurs, i.e., there is a transaction between the taxpayer entity and another entity giving rise to a sufficient entitlement of an income nature; or on the facts present an amount is included in assessable income by operation of law, e.g., trading stock is manufactured and is on hand at the end of the income year requiring a value to be taken into account under sections 70-35 and 70-45. The use of this term supports the view that notional income is not created by subsection 136AE(4)[56]. As subsection 136AA(1) reinforces, 'derive' is used here not in contradistinction to other terms used in the Act to define the time when amounts are included in assessable income (such as 'paid' or 'received') but rather as a generic term for all those cases where amounts are included in income. This usage is common in the ITAA, e.g., subsection 160AF(2).

DTAs

4.51 In the business profits article of DTAs, the relevant term is usually 'profits of an enterprise.' Paragraph 2 of that article indicates that such profits are to be determined in accordance with the arm's length separate enterprise principle, while paragraph 3, to which paragraph 2 is expressly subject, provides that 'In the determination of the profits of a PE, there shall be allowed as deductions expenses of the enterprise …'. The Agreements Act, incorporating DTAs into Australian law, provides in subsection 3(2) that 'a reference in an agreement to profits of an activity or business shall, in relation to Australian tax, be read, where the context permits, as a reference to

[56] See paragraphs 2.13 to 2.14 above

taxable income derived from that activity or business'. This link between the terminology of the DTA and the ITAA was considered necessary because the ITAA provides for tax to be assessed and paid by reference to the 'taxable income' of a taxpayer, not profit[57].

4.52 It is not considered that subsection 3(2) means that the usual calculation of taxable income as assessable income less deductions under section 4-15 can be ignored in the DTA context. Rather, the provision indicates that the profit concept is to be interpreted consistently with the calculation of taxable income under the ITAA and that, consistent with the approach under section 136AE, the business profits article under DTAs is applied to items of income and expenditure rather than invariably to a net amount of profit. Where assessable income is itself a net concept (so that no further costs generally apply as deductions in reducing assessable income to taxable income) assessable income, taxable income and profit will be the same.

4.53 The business profits article in DTAs usually provides that items of income dealt with in other articles are taxed under those articles unaffected by the business profits article. A number of other articles (dividends, interest, royalties and other income), however, provide income otherwise covered by those articles which is connected to a PE is taxed under the business profits article, thus returning the income to the latter article. Apart from these exceptions, other income of a business nature, however, remains covered by the other articles, not the business profits article. In some of these cases, the taxation rules in the other articles have no dependence on connection with a PE (such as income from real property and gains from the alienation of real property and international transport). In others of these cases, connection to a PE or something very similar to it (e.g., connection with a fixed base for professional income) is introduced.

4.54 Domestic law sometimes reflects an approach similar to that in treaties, e.g., interest derived by a non-resident[58] or expressly acknowledges the different position under treaties, e.g., royalties derived by a non-resident.[59] The operation of subsection 136AE(4) is not, however, directly subject to these variations. It applies to business income generally which is related to a PE[60] and in that sense is different in scope to the business profits article. In practice, however, the difference is unlikely to be important. Where the PE concept is relevant to taxation of business income under domestic law

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57 See Explanatory Memoranda to Income Tax Assessment Bill 1947 at 52, Income Tax (International Agreements) Bill 1953 at 15.

58 See subsections 128B(2) and (2A) and subparagraph 128B(3)(h)(i)

59 See subsections 128B(2B) and (2C) and Agreements Act subsection 17A(4)

60 See paragraphs 136AE(4)(a) and (e)

or under DTAs, subsection 136AE(4) and the business profits article will usually be the relevant provisions for tax purposes.

4.55 The question whether the business profits article of certain older DTAs applies to capital gains has been much debated in Australia. In modern treaties such as the Vietnamese agreement Article 12, an alienation of property article deals comprehensively with capital gains so that the issue is unlikely to arise with such treaties[61]. The ATO is currently progressing this issue in various ways and it is therefore not intended to rule on that matter in this Ruling.

Expenditure

ITAA

4.56 The term 'expenditure' includes losses and outgoings[62]. Accordingly, section 136AE will impact on all the provisions of the ITAA that are concerned with losses and outgoings[63] and also those that are concerned with capital allowances and non-allowable items.

4.57 The phrase 'expenditure incurred in deriving income' is also a defined term[64] and includes expenditure incurred in carrying on a business for the purpose of deriving income. Accordingly, subsection 136AE(4) will apply to any expenditure that may be an allowable deduction under section 8-1. It also applies to expenditure which is not allowable, such as, amounts related to exempt income. The principal limitation surrounding the use of the word 'expenditure' is whether the context, i.e., the relevant provision of the Act, involves a source question. Thus virtually everything except a few areas where the law provides entitlements regardless of source (charitable donations[65] and losses on disposal or redemption of traditional securities[66]) would be covered.

4.58 In the same vein as what is said above regarding the meaning of 'derived', the word 'incurred' refers to expenditure in fact incurred.

DTAs

Paragraph 3

4.59 Although paragraph 2 of the business profits article is expressed to be subject to paragraph 3, the ATO considers that it is not

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61 The issue might arise with CGT events under Division 104 which do not involve an alienation of property, e.g. Event H2, section 104-155.
62 Subsection 136AA(1)
63 Section 8-1
64 Subsection 136AE(8)
65 Section 30-1
66 Section 70B

the purpose of paragraph 3 to set out special rules for expenses that are in some sense inconsistent with the operation of paragraph 2, in particular the arm's length separate enterprise principle. Rather, paragraph 3 has three purposes in the form that it appears in most of Australia's treaties. First, the phrase 'whether incurred in the Contracting State in which the PE is situated or elsewhere' makes clear that a party to the treaty cannot apply rules that it may have in domestic law which deny deductions for expenditure incurred outside the country in calculating taxable profits. A number of countries around the world have such rules in domestic law but Australia does not.

4.60 Secondly, the phrase 'being expenses incurred for the purposes of the PE (including executive and general administrative expenses so incurred)' is intended to allow apportionment of general expenses of the enterprise which partly relate to the PE. Such apportionment is not an issue under Australian law, which contains many apportionment provisions for deductions; e.g., 'to the extent to which' in section 8-1. Some countries have strict rules preventing apportionment and denying deductions where expenditure do not relate entirely to income taxable in that country, but such rules cannot be applied in a treaty context to disallow expenditure which relate partly to a PE in that country.

4.61 Thirdly, the words 'which would be deductible if the PE were an independent entity which paid those expenses' are interpreted to mean that domestic law rules limiting deductibility (other than those in the first two cases above) are not overridden by the arm's length separate enterprise principle. Thus, Australia can deny entertainment expenses of a PE in accordance with Division 32 of the ITAA 1997, even though such amounts are properly treated as expenditure in calculating accounting profits. These words are not found in the OECD Model Convention but, in the ATO's view, the same result applies even under treaties that follow the OECD wording[67]. Similarly, interest expenses may be disallowed or reduced in accordance with Division 16F or Part IIIB of the ITAA 1936.

Only actual deductions allowed

4.62 Putting aside the provisions of paragraph 3, several issues arise in the deductions area. It was indicated above that, both under domestic law and tax treaties, Australia works with actual income and deductions of the taxpayer and uses the arm's length separate enterprise principle as a means of allocating income and expenditure.

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[67] See *Utah Mines Ltd* 92 DTC 6194 where it was held that a provision in the OECD form did not override a provision of Canadian law denying deductions for mining royalties paid to provincial governments

It follows that, under DTAs, only items that are deductible to an enterprise may be used in the calculation of the profits of a PE, that is, notional expenditure such as 'payments' to head office are not deductible.

4.63 Further, in working out the allocation of income and deductions through the arm's length separate enterprise principle, it is important to avoid double counting. For example, if trading stock is transferred from a head office to a PE, the transfer price will include overheads up to the point of transfer. Hence, it is not appropriate to attribute those overhead expenses of the head office to the PE in calculating the income of the latter. It is only other overhead expenses that relate to the PE that can be so attributed.

4.64 It is suggested in paragraphs 17.4 to 20 of the OECD commentary that special principles may apply to intangible assets, certain management activities and payments under the name of interest on internal debts of enterprises other than banks. These special principles are that there is no mark up on actual expenditure to third parties and that there is no notional expenditure between a head office and a PE where there is no actual expenditure to third parties. The OECD approach in this regard is consistent with the principles applying to these and other types of expenditure under Australian law. This is the case despite acknowledgment above that the allocation of actual income and expenditure can be effected through the application of the arm's length principle taking into account all dealings between the head office and PE (including dealings involving intangibles, services and financial structure of the PE).

4.65 Further work is occurring in the OECD in this area and the Ralph Report has recommended that Australia progressively introduce a separate entity treatment[68]. Hence, Australian practice may evolve in the future. There are also particular difficulties in a number of areas which mean that it is difficult in some cases to use allocation of income and expenditure[69], and in other cases, to apply mark-ups or a profit element in arm's length transfer prices used in the allocation process[70]. Finally, because actual transactions do not exist in the PE it is more likely that aggregation and profit split type approaches will be used rather than allocation of individual items of income and expenditure. All these factors mean that there may be some variation in the PE area from the principles applied between separate enterprises. Special considerations relating to financial enterprises are discussed further below[71].

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68 Recommendation 22.11(a)

69 See the discussion of trading stock in Chapter 6

70 See the discussion of startup and ending of a PE in relation to R&D expenditure at paragraph 4.85 and those following.

71 See Chapter 6

4.66 Australian law allows deductions for certain items that do not strictly relate to particular income, such as donations to charity. It is considered that these deductions operate in accordance with their terms and are outside the operation of the business profits article. Hence, even if a charitable donation is made by a head office outside Australia in a way which qualifies for deduction in Australia under the income tax law, that deduction can be taken against the assessable income of the enterprise generally, including profits attributable to a PE of the enterprise in Australia. Similarly, the special allocation rules that apply to such deductions for foreign tax credit purposes[72] are not affected by the business profits and double tax relief articles in tax treaties.

Capital (interest free funding)

4.67 In allocating income and deductions through the arm's length separate enterprise principle, it is important to recognise that an independent enterprise could not operate without adequate equity capital. Accordingly, an appropriate level of capital must be allocated to a PE in order to support the functions performed, assets used and risks assumed. Further discussion of issues relating to financial dealings and funding occurs in paragraphs 6.6 and 6.38 to 6.65.

ITAA

4.68 Division 16F (thin capitalisation) and Part IIIB (foreign bank branches) may operate to deem or otherwise attribute a certain minimum level of interest free funding to a PE. Consistent with the discussion on expenditure in paragraph 4.61 above, these domestic provisions are not overridden by the arm's length separate entity principle.

4.69 Further work is occurring in the OECD in this area and the Ralph Report has made specific recommendations relating to minimum capital and thin capitalisation requirements for PEs and foreign bank branches[73]. These recommendations include the requirement for all PEs in Australia to prepare financial accounts. This includes the preparation of a balance sheet (also known as a statement of financial position). The balance sheet for the PE will require an allocation of assets, liabilities and capital.

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[72] See the treatment of apportionable deductions in section 160AF

[73] Recommendations 22.11(b) and (c); 22.4(a).

DTAs

4.70 It is considered that the arm's length separate entity principle requires that an appropriate level of interest free capital of the entity be allocated to a PE as part of the profit attribution calculation. The amount of interest free capital or ratio of debt to equity in each case will take into account the different functions performed, assets contributed, and risks assumed by each branch.

Losses

ITAA

4.71 It follows from the allocation of income and expenditure approach adopted for the PE area and the fact that section 136AE operates across years of income[74] that it is possible as a result of a determination to have a profit in a head office and a loss in a PE and vice versa, or a decreased or increased loss in a PE or head office. A determination can only be made however where the tax result has the potential to increase tax payable[75].

DTAs

4.72 The ATO considers that the reference to profits in the business profits article is not to be interpreted literally, so excluding losses. Given that losses can be carried forward indefinitely, it would be a strange outcome if the method of calculation changed from year to year depending on whether an enterprise was in profit or loss.

4.73 If 'profits' in the business profits article do not include losses, the result would be that in calculating the position in a non-profit year, the taxpayer would revert purely to domestic law. This would mean in the case of a non-resident with a PE in Australia, that the existence of a PE and the attribution of income and expense to the PE, would become irrelevant and the outcome would under sections 6-5 and 6-10 be determined under the general sourcing rules in Australian law and allocation of deductions to that income. Any loss so determined could then be carried forward to be used against a profit to which the treaty calculation applied even though the loss may be greater (or less) than it would have been if a treaty consistent calculation had been used in the loss year.

4.74 Indeed, as it would be possible because of the great difference in these calculation methods to have a profit under the treaty method and a loss under the domestic method. In such a case, the treaty calculation would prevail with the result that it would be necessary to

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[74] See paragraph 4.2 above

[75] See paragraphs 4.1 and 4.2 above

do both the treaty calculation and the domestic calculation before it was clear that a loss was available. Further, it would be possible to have an outcome of a loss under the treaty method and a profit under the domestic method with the result presumably on this view that Australia could tax the profit even though the treaty method produces a loss.

4.75 Further, the provisions in the dividends, interest and royalties articles which require application of the business profits article where the relevant property is effectively connected with a PE are not limited to cases where the business profits article produces profit. It would be very odd if a payment were removed from these articles on the basis that the business profits article would apply only to find that the latter article does not apply because of a loss position.

4.76 Hence, it is considered that the provisions of the business profits article will apply whether a profit or loss results, notwithstanding possible arguments to the contrary based on Article 3(2) of tax treaties under which undefined terms take their meaning from domestic law[76] and subsection 3(2) of the Agreements Act which equates business profits to taxable income (that is, cases where there is no loss). Both provisions are subject to context and clearly here the context indicates otherwise for the reasons given above. In other words, the outcome under treaties is similar to that under Division 13 in this area.

Exempt Income

ITAA

4.77 One of the main spheres of operation of subsection 136AE(4) will be to determine to what extent income is, or is not, exempt under section 23AH (foreign branch income). Generally in this context, a determination under subsection 136AE(4) can operate either to reduce the amount of income of a foreign branch or to increase expenditure allocated to the branch; these cases can satisfy the condition of exercise of the power to make a determination relating to the tax result of the adjustment.

4.78 It should be noted, however, that the definition of PE is different in section 23AH compared to subsection 136AE(4) and that foreign income in section 23AH does not include capital gains. These differences in coverage will not make any practical difference in most cases.

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76 *American Thread Co* (1946) 73 CLR 643.

DTAs

4.79 The equation of business profits to taxable income in subsection 3(2) of the Agreements Act can have no relevance to section 23AH where the operation of the DTA in combination with the usual source article in Australia's treaties which flows into domestic law is to exempt the profits from tax. It is to be noted also in this context that the PE definition in section 23AH is aligned to the treaty definition in cases where a treaty is applicable. It is considered that this is another case where the equation of profits to taxable income by subsection 3(2) is excluded as the context indicates otherwise.

Duration of the PE

4.80 Issues arise in relation to the allocation of income and expenditure which is related to the activities of a PE but which is derived or incurred when the PE is not in existence. For example, a PE that sells equipment may have to meet contractual or statutory warranty claims after the PE closes down its business, arising out of sales made while the PE was carrying on business[77].

ITAA

4.81 The normal calculation of taxable income does not depend on the existence or otherwise of a PE but this Ruling deals with several provisions in domestic law which do depend on the existence of a PE, such as, subsection 136AE(4) and section 23AH. The power to make a determination under subsection 136AE(4) does not explicitly require that the PE exists in the same income year as the allocation of the income or expenditure occurs (when the income is derived or the expenditure incurred). The wording of subsection 136AE(1) may be considered to imply such a connection (a taxpayer *carries* on a business at or through a PE). On the other hand, it has already been noted that the provision in subsection 136AE(4)(d) dealing with the tax result can involve other years of income. Similarly, it is considered that requiring the continuance of the PE for the income year to which a determination relates would restrict the power in a way which is not consistent with its purpose of ensuring that Australia receives its fair share of tax from international transactions involving PEs.

4.82 In the case of section 23AH, the arguments for the existence of the PE when deriving foreign income to obtain the foreign branch

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[77] Compare *Placer Pacific Management Pty Ltd* 95 ATC 4459. If the expense is not deductible under s 8-1 because it is regarded as having lost any relevant connection with the income, the issue discussed here will not arise.

exemption may be considered to be stronger. There are several indications of such a connection in the provision:

- The requirement that foreign income is *derived in carrying on* a business at or through a PE (paragraph 23AH(1)(b));
- the tying of the income closely to income years and tax accounting periods (throughout subsection 23AH(1));
- the tying of the exemption to periods of residence (subsection 23AH(2)) which links to the residence and source rules of section 6-5 (which require residence or non-residence to be tested in the year income is derived).

DTAs

4.83 Article 7 contains no specific timing link between the existence of the PE and the year when income is derived or expenditure incurred. The OECD Commentary on Article 5 paragraph 11 gives some tests for when a PE may be regarded as commencing or ceasing operations but not in a way which gives a clear indication on this question. Nonetheless, the view has been expressed that the central issue is whether the relevant income or expenditure arose from the activities of the PE in applying the attribution test, not whether the PE is in existence when the income or expense is brought to account for tax purposes[78]. The ATO considers that this view will be followed in Australia.

4.84 Hence, a taxpayer could deduct warranty expenditure arising out of a PE's activities even after the PE closed down (taking the example at the outset of this section[79]) and, likewise, could include as income attributable to a PE after it had closed instalments of an instalment contract to sell equipment if those instalments would be derived under domestic law in later years[80].

Research and development ('R&D')

4.85 In some cases, the link between the PE and the income or expenditure is clear. In other cases, the link cannot be made as easily, particularly for R&D. Quite often firms spend large sums on R&D and, many years after the incurring of the expenditure, begin to derive significant income from the relatively small part of the R&D which

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78 Vogel K., 3rd edition, 1997, page 410.

79 At paragraph 4.80

80 In most cases such income would be treated as being derived when the contract of sale was entered into.

has been successful. During the same years the firm may set up PEs in some countries and close down PEs in other countries. At any given time all parts of the firm, including the various PEs then in existence, contribute to the current R&D. It may be possible to trace the parts of the firm which contributed to the intellectual property from which the firm is currently deriving its income. The firm itself may in fact be operating on the basis that today's income is linked to today's R&D, or is linked to all the R&D in the past, rather than being based on particular past R&D.

4.86 In this context, a number of possibilities for calculating PE income arise. The property producing current income could be attributed to the parts of the enterprise that financed the R&D and produced the property (for instance in accordance with contributions). As noted above the current parts of the enterprise could not then be regarded as, in effect, paying a royalty for the use of the property by allocating current income. This would imply attributing income to some countries where PEs have long since ceased to exist while also allowing deductions to current PEs for a share of current R&D as well as the implicit royalties in the allocation process.

4.87 Another possibility would be to apply a joint venture analogy. Broadly, under that analogy current PEs bear a share of current R&D expenditure in exchange for current income arising from past R&D (i.e., not bringing any notional royalty into the allocation process). The way in which R&D expenditure and their results are dealt with will depend on the facts of the particular case. Where there are long lead times and a consequent disassociation of income and expense, the joint venture approach may prove the most practical.

Intermittent PEs

4.88 A related issue arises where a PE is intermittent, e.g., a PE is constituted by substantial equipment which is moved in and out of a country for seasonal, economic cycle or logistical reasons (such as being based elsewhere).

4.89 In such cases, at least two questions arise. Can income produced by the operations in a country when a PE is in existence be allocated to periods when the PE was not in existence to reward other parts of the enterprise for the activities undertaken in relation to the equipment? Secondly, can expenditure incurred while there is no PE nonetheless be attributed to the operations of the PE, e.g., repairs outside the country, mothballing expenditure, etc? The answer to the first question would appear to be 'no', as the discussion of 'asset allocations and capital allowances' in Chapter 6 indicates. The following example and discussion deals with the second question.

Example

4.90 A non-resident company, ForCo, leases an oilrig from a related non-resident company to undertake exploration activities in Australian waters during a 9-month contract. The oilrig constitutes an Australian PE of ForCo during this period. The oilrig undergoes repairs in the following circumstances:

(a) Immediately before coming to Australia ForCo incurs expenditure on repairs to prepare the oilrig for the exploration work under the contract.

At the time that the repairs are undertaken the Australian PE of ForCo does not exist. A deduction is not available under Australian domestic law for repairs undertaken prior to the exploration rig being held for assessable income purposes. Further, under the treaty no amount of the expenditure is attributable to the PE because the repairs did not coincide with the period of use of the oilrig for carrying out the PE activities.

(b) During the period of the exploration work the rig is damaged and is shipped back to Singapore for necessary repairs.

The income derived under the contract is attributable to the PE and assessable as income derived from sources in Australia. Notwithstanding that the rig is temporarily out of use, the expenditure on repairs are wholly or partly deductible under sections 8-1 and 25-10. Having regard to the circumstances under which need for the repairs arose and the timing of the expenditure, the repairs are attributable to the PE activities and should be deducted, in full or in part in calculating the attributable profits.

(c) The contract in relation to the Australia exploration is completed. ForCo allow the oilrig to remain in Australia pending its next assignment, which could be anywhere in the world. A maintenance team remains on the rig and carries out repairs.

It is considered that the Australian PE of ForCo ceased when the oil drilling (i.e., the use of the oilrig) in Australia came to an end and the relevant contract was completed. A deduction may not be available under section 25-10, as the oilrig was not held for assessable income purposes at the time the repair expenditure was incurred. However, a deduction may be available under section 8-1 and under the treaty depending on whether the repairs were related to the use of the oil rig

for the exploration work or the need for on-going maintenance while it was moored after the PE activities ceased.

4.91 Deductions available to a taxpayer under the repair provision may not be wholly attributable to an Australian PE of the taxpayer due to the operation of the attribution rules. Difficulties may arise in establishing the extent to which the need for repairs arose prior to the active use by an Australian PE. Where the repair expenditure relating to defects, damage and deterioration arose solely from the use of the property by the Australian PE of the entity for assessable income purposes, the whole of the repair expenditure will be attributable to the Australian PE. On the other hand, any portion of the repair expenditure relating to defects, damage and deterioration arising while the property was used or held by other parts of the entity and not for the purpose of earning assessable income will *not* be attributable to the Australian PE of the entity, notwithstanding subsection 25-10(1). It is considered that apportionment in this context is different to that under section 25-10 and Taxation Ruling TR 97/23 dealing with deductions for repairs generally because they do not involve questions of attribution.

4.92 Where it cannot be established that the need for repairs arose solely in relation to the use of the asset by the Australian PE for assessable income purposes, a reasonable apportionment of the repair expense relating to the Australian PE will need to be determined under the attribution provisions. In determining the quantum of the deduction allowable, factors that may be relevant include the following:

(a) the date of the last repair expenditure;

(b) where there has been no prior repair expenditure by the entity, the date of purchase of the asset by the entity; and

(c) whether the need for repair arose partly in relation to an identifiable incident (for example, an accident, cyclone, fire) and the extent to which the incident contributed to the deterioration or damage.

4.93 Where an insurer incurs the repair expense, no deduction will be available to the taxpayer in relation to the repair as the taxpayer has not incurred the expense and no expense is attributable to the Australian PE. However, if the taxpayer incurs deductible repair expenditure and later receives an insurance payment in relation to the same repair, the insurance receipt will be attributable to the Australian PE to the extent that repair expenditure was attributable to the Australian PE. Therefore, where only part of the repair expenditure was attributable to the Australian PE because part of the defects, damage or deterioration resulted from use or holding of the property

by the taxpayer prior to the taxpayer using it for assessable income purposes, the insurance receipt will be attributable to the Australian PE to the same extent as the repair expenditure.

Special treaty rules

4.94 Australia's tax treaties typically contain two special rules about calculation of business profits. Article 7(4) of the Vietnamese agreement provides that no profits shall be attributed to a PE by reason of the mere purchase by that PE of goods or merchandise for the enterprise. As a purchasing office on its own would not give rise to a PE because of the preparatory and auxiliary qualification to the definition of PE,[81] this provision will apply where there is a PE arising from other activities which also carries out purchasing activities. In this event, no profits will be attributable to the purchasing activities.

4.95 Secondly, Australia preserves the operation of its domestic rules in relation to insurance with non-residents[82]. These rules are found in Part III Division 15 of the ITAA 1936. Given that this Division in effect forms a code for the taxation of non-resident insurers in a way which does not rely on the PE concept, insurance is not considered further in this Ruling.

Chapter 5: Methodologies

Introduction

5.1 In predicating the circumstances that would have, or might reasonably be expected to have, existed if the PE were an independent entity dealing at arm's length, it is useful to keep in mind that the object is to allocate income and expenditure / profit of the enterprise between the PE and other parts of the entity. As has been discussed, this process also involves the allocation of assets, liabilities and capital. The independent entity hypothesis and the accepted transfer pricing methodologies are tools for achieving a sound practical outcome.

5.2 The application of the arm's length principle in the PE context will be similar to its application to associated enterprises in the sense that, in both the PE and associated enterprise cases, the characteristics of the particular business activity and the economic substance of operations at and between the relevant places will be important for determining the income, expenditure and profit attributable. Such matters are discoverable by undertaking a functional analysis.

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[81] For example, Vietnamese agreement Article 5(3)(d)

[82] For example, Vietnamese agreement Article 7(7)

5.3 However, the conceptual and practical difficulties of developing a sound arm's length hypothesis are greater when dealing with PEs because some important aspects of the PE business operations may not be available whereas they would necessarily be known if the same operations were sited in a separate legal entity, e.g., capital structure.

5.4 The Australian approach to the problem is to construct a hypothetical entity fitting the PE's circumstances. To the extent necessary for attributing income, expenditure and profit, the hypothetical entity will be given a capital structure, assets and liabilities, an independent management and business strategy. However, as explained earlier the possible outcomes are not entirely open. The independent entity construct is in effect carried only so far as to allocate properly for tax purposes the results of the enterprise's operations between its PE and head office, or between PEs.

5.5 Obviously, practical difficulties can arise in relation to the PE attribution. However, in the end, there is always a basis found for allocating income and expenses for it is necessary under the taxation law to arrive at a result. The observations at paragraphs 3.88 and 3.89 of Taxation Ruling TR 97/20 and paragraphs 55 to 57 of Taxation Ruling TR 1999/1 are applicable in relation to the standards for acceptance of any particular solution to allocation issues.

Segmentation - Accounting practice and taxation

5.6 It is normal commercial practice for some form of separate accounts to be kept for a PE. The accounts may treat internal transfers as if they were transactions entered into with an external party. Where separate accounts are kept and have been prepared in accordance with proper accounting principles and practice they may serve as a starting point for the construction of an economic model of the PE or PEs depending on the segmentation adopted and the characteristics to be attributed to the PE.

5.7 The discussion of the use of accepted arm's length transfer pricing methodologies in the context of PE attribution issues is aided by reflection on some identifiable phases in the segmentation of entities. It is helpful to recognise the particular place of the methods within the broader process and to draw attention to the potential for alignment of tax and management accounting.

5.8 Logically, the first phase for segmentation must be the identification and characterisation of the relevant segments. For management purposes, the entity will have its own particular criteria for segmentation. Mostly, the segments chosen will reflect functionally distinct units of the overall productive or commercial process. Even where not documented, the basis underpinning the

segment accounting framework should be reasonably apparent from a functional analysis.

5.9 Having identified the segments, the next logical phase is the assembly of the data in relation to the income, expenditure and assets and liabilities on a segment basis. To a large extent, the segment accounting framework, as originally established or evolved, will determine how items are allocated and apportioned. The policies and procedures, which will not be static, will be primarily designed to serve the interests of management in adequate reliable information for decision making, accountability for resources, control and evaluation of performance. Non routine allocation or apportionment issues may arise from time to time, requiring a decision by the accountant or management and perhaps leading to a modification of accounting policies. However, the implementation of the process will tend to be a matter-of-fact exercise governed by the nature of each segment's business activities and the connection or relevance of transactions underpinning allocations. Sales would be expected to be recorded in the accounts of the segment doing the selling, manufacturing costs charged to the manufacturing segment, and so on. Care needs to be taken in considering the implication for segment accounts of assets used and risks assumed. In many cases, the entity will not have made a notional charge or allocation to reflect the economic costs of assets used and risks assumed as these are simply handled at the entity level. Funding costs (i.e., interest and borrowing costs) would need to be allocated against the segment operating results having regard to the segment's capital requirements.

5.10 Determining the inter-segment charges completes the matching of income and expenditure at the segment level. At this third phase of the process, segment income may be reallocated based on the contributions of the relevant functional units to the generation of entity income and profit, having regard to their characteristics.

5.11 For taxation purposes, Phase 1 must separate the activities carried on in and out of Australia; the PE needs to be regarded as a segment. For Australian businesses and foreign firms with business in Australia, distance between domestic and foreign markets/places of business may be a significant factor for operational purposes and, accordingly, it may be expected that a PE will usually be a separate segment under the firm's organisational structure and accounting framework. However, new ways of doing business made possible by improvements in communication technologies and the increasing acceptance of the Internet for world-wide marketing may mean that it will no longer make sense for management purposes to view performance of some forms of business on a geographically segmented basis. When this situation occurs, the solution of the attribution issue lies in the development of a sophisticated contribution analysis for allocation of the profit rather than

constructing PE tax accounts that would not otherwise exist. Global trading of financial instruments may be a case in point. However, even in this area, the need for management to control and account for costs at the branch level will present the operational requirement of segment accounting combined with a contribution analysis to apportion the global profit from trading at a gross level. It may also be necessary to construct a notional balance sheet for the PE to account for assets and liabilities and to address capitalisation issues.

5.12 Deemed PEs is the area where segmentation for normal business purposes and tax purposes may not coincide. Some issues specifically related to deemed PEs are dealt with separately in Chapter 6.

5.13 Phase 2 of PE accounting is essentially the same process as for management accounting because it too is premised on the allocation and apportionment of incomes, expenditures, assets, liabilities and capital on a rational, factual basis. However, 'rules' of allocation and apportionment that may be acceptable having regard to the standard of information required for management will not necessarily be acceptable for taxation purposes, which requires reference to the characteristics implicit in the PE.

5.14 If, for instance, the circumstances were to suggest that, under the management accounts, the PE has expenditure that it would not be expected to bear or which it should have absorbed if it were independent and dealing at arm's length, the position would need to be adjusted for tax purposes. However, the nature of the adjustment may vary according to the underlying cause. Three main possibilities may be expected. One is that there has been a basic accounting error. The solution will be to correct by appropriate accounting entry bringing the accounts into line for management and tax. A second is that the entity does not properly implement the independent entity assumption in its segment accounting (perhaps for operational reasons / convenience). An example would be where there had been no allocation of capital to the segment affecting the amount of interest expense charged against the segment profit. In that case, the appropriate response is an adjustment to expenditure allocations for tax purposes only. A third scenario is that what appeared to be an expenditure allocation or apportionment issue is really an income allocation issue; that is the accounts as prepared reflect service functions and point to dealings between segments that have not been properly recognised. This kind of issue falls for consideration under a third discernible phase of the segmentation process. Phase 3 is a critical part of the process where accepted arm's length pricing methodologies will be relevant and often essential for valuing intra-entity dealings.

5.15 At the end of this Chapter on Methodologies, an example is provided to illustrate the way in which the segmentation may occur under an accounting framework with the objective of providing sound segment profit data for taxation purposes.[83]

5.16 It may be seen from this discussion, that the broad methodology for dealing with PE attribution issues is to answer each of the following questions:

- Is the segmentation adopted by the entity the appropriate accounting framework for taxation purposes? In other words, is there a set of accounts, for management or external reporting, that properly reflect the functions carried on at or through the PE and the characteristics of the PE including assets, risks and financing? If there is not then it will be necessary to adjust or construct PE accounts or if this is not practicable, undertake a detailed contribution analysis, to serve as a basis for the economic modelling of the PE.
- Under the segment accounts, are the allocations of actual income, expenditure and other items correct having regard to the functions carried out, the assets used and the risks assumed? If they do not appear correct, what is the nature of the underlying cause? It may be necessary to correct the 'primary' income, expense, asset, liability and capital allocations if that is the problem.
- Given the functions carried on and the relationship between segments, what dealings exist? Are these recognised in the segment accounts by inter-segment charges?
- What methodology has been used for calculating the inter-segment charges? Is the methodology appropriate and are the calculations correct?

5.17 After possible correction to segment accounts for primary allocation issues, the valuation of intra-entity dealings is at the heart of the attribution issue. As intra-entity dealings are analogous to separate entity dealings the opportunity presents for the use of accepted transfer pricing methodologies.[84] Example 3 below illustrates the way the accepted transfer pricing methods may be applied to allocate enterprise income.

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[83] See Example 2

[84] Refer Taxation Ruling TR 97/20 paragraphs 3.5 to 3.9

A Structured Process for Modelling Attribution Issues

5.18 The observations in the Taxation Rulings TR 97/20 and TR 98/11 on arm's length transfer pricing methodologies and documentation and practical issues associated with setting and reviewing transfer prices in international dealings are generally applicable to selection and application of methodologies in the PE context.

5.19 The questions raised in paragraph 5.16 can be answered through an extended version of the four steps recommended in Taxation Ruling TR 98/11 and set out in Chapter 1 above. This is discussed further here to identify PE specific issues.

Step 1.1: Identify the economically significant activities carried on by the entity

Data Collection / Organisation	Action / Evaluation
Characteristics of the products/services involved and markets/segments involved Type and location of activities carried out Assets employed - tangible and intangible - and how they were developed or obtained Sources of risk Source and use of critical information Organisation, decision processes and systems, incentive structures	Identify the ways in which value is created or added Prepare a preliminary functional analysis, identifying primary and support activities and their location Explain the conditions affecting the industry, business and the business strategies available / adopted in each relevant location Ascertain which of the activities carried on are economically significant Link assets used (tangible and intangible, including human resources) to activities
Business objectives, strategies adopted Financial performance Conditions in each relevant market (e.g., competition, regulatory factors) Dealings with associated entities	Link risks and their management to activities Link information flows to activities

5.20 This first step is intended to produce an accurate overall picture of the enterprise and its business segments. In particular, it is important to establish the ways in which value is created within the enterprise and the markets served by these processes. As indicated in

Taxation Rulings TR 97/20 and TR 98/11, a functional analysis will always be an important element. It may be necessary to build on the analysis undertaken for choosing the segments that make up the operational structure and for primary income and expense allocations under accounting policies. It will normally be necessary in approaching the attribution issue to understand the relationship between the enterprise's segments on one hand, and the relationships with associates and independent parties on the other, in order to understand where the substantive contributions to economic value arise.

5.21 In many of the diverse PE contexts that now exist, or are likely to emerge, the basis for economic value creation often lies in the intangible assets or resources of the enterprise. It is important then to establish the resources that are used. This includes the skills and knowledge of the staff involved, the data bases that they use (including development, maintenance and access issues), the use of software (including development, maintenance and access), the extent and sophistication of the IT systems relied on (including development, architecture, support and access), and the knowledge held within each part of the enterprise. As well as these often critical assets and resources, this first step must identify the sources of risk and the ways in which these are handled (allocated) within the enterprise as a whole. Specific attention needs to be paid to the ways in which risk is transferred from one part of the entity to another, and to the economic consequences that could or should flow from these transfers.

Step 1.2: Postulate the existence of one or more permanent establishments - do they pass the threshold test?

Data Collection / Organisation	Action / Evaluation
Facts relating to tests in PE definition DTA Article 5 / section 6 ITAA 1936 definition.	Decide whether a PE exists and consequentially an attribution question arises.

5.22 Specific concerns likely to arise here stem from the interpretation of Article 5 in the DTA, where, in paragraphs 5(3)(a), (b) and (c) an enterprise shall not be deemed to have a PE merely by reason of the use of facilities or the maintenance of a stock of goods solely for purposes of storage, display or delivery of goods, or further processing. Article 5(3) goes on in paragraph (d) to exclude a PE where the sole purpose is the purchasing of goods or the collection of information, and in paragraph (e) to exclude a PE where the sole purpose is the conduct of preparatory or auxiliary activities, including

advertising.[85] Where the prime purpose of the entity as a whole lies in the provision of services, often involving a central role for information, there is clearly need for care. The authority to conclude contracts for the purposes of paragraph 5(3)(e) is an important test.

Step 1.3: Identify the activities where the PE plays a role - directly or indirectly

Data Collection / Organisation	Action / Evaluation
Geographical location of relevant assets, operations and management Where activities are not conducted directly note what kind of arrangement is used for carrying out of activities away from place of residence, e.g., an agency	Identify significant economic linkages between PE and entity Analyse the economic geography of the entities activities Identify activities which are conducted in and out of Australia Determine the boundaries of the postulated PE or PEs

5.23 The analysis should ascertain not only which functions are performed by the head office and each PE, but also in what capacity they perform those functions. For instance, a PE or head office, viewed as a separate entity, may perform activities either as a principal (accepting all the risks and entitled to a commensurate share of the profits of the activity), or as an agent for or on behalf of another part of the MNE (with limited risks and for a limited return).

[85] Refer OECD Commentary on Article 5 at para 24.

Step 1.4: Identify the scope, type, value and timing of the dealings of the PE

Data Collection / Organisation	Action / Evaluation
Transactional and Accounting records, including segment accounts (and the basis for the segmentation used), management policies, accounting rules, legislative and requirements in each jurisdiction	What dealings of the entity are connected with the PE business (as defined) and form a basis for allocation of income, expenditure, assets and financing / preparation of accounts.
Information about transfers of assets (tangible and intangible) or provision of benefits between the PE and other segments/components of the entity	What dealings should be implied having regard to the economic relationships between the PE business and other parts of the entity
Information about sharing of assets and resources (including financing)	What dealings should be implied having regard to the information needs of the PE and other entity parts.
Information about sharing of risks	
Information about timing of dealings, especially in financial and similarly volatile market settings	Income and expenditure tests (section 136AE)
	Is aggregation over time or dealings possible or necessary?
	Is there more than one PE?

5.24 In this step, the critical activities are to use the segment accounts, suitably adjusted, to provide a reliable basis for the construction of an economic model of the PE. Attention must be paid to the implied dealings arising from the use of assets held by the entity, the sharing of risks, and the financing undertaken. Where the limitations arising from the application of section 136AE in allocating income and expenditure are encountered, the possibility of aggregation over time (e.g., the use of multiple years of data) or transactions (a grouping approach) should be considered.

Step 1.5: Determine the character and structure of the PE business

Data Collection / Organisation	Action / Evaluation
Understanding of the data collected under the earlier steps	Construct an accurate view of the nature of the business if all significant activities identified earlier were carried on by an independent enterprise. Consider and choose appropriate structural analogues Determine the capital structure or other characteristics it may have if carried on by an independent enterprise.

5.25 The identification of structural analogues to the PE relationship may be helpful in linking the PE analysis under the assumption of arm's length dealings to a parallel or analogous situation involving subsidiaries. Examples include businesses carrying on comprehensive manufacturing, mining, distribution, marketing, provision of services, contract manufacturing, agency relationships, cost contribution arrangements and joint ventures. Example 1 below provides a case study that in the context of a functional analysis discusses the choice of an appropriate model for attribution of profits to a PE.

Step 2: Select the most appropriate methodology for attribution purposes

Data Collection / Organisation	Action / Evaluation
Review the information gathered under steps 1.4 and 1.5 Information about how similar operations are conducted by third parties Potential for obtaining good data for comparability analysis; timing issues	Choose TP methodology to apply overall or to specific categories of dealings Document process

5.26 The use of some of the accepted transfer pricing methods (e.g., CUP, cost plus and resale price methods) in this context should bring into account the relationship of the internal dealings to which the

arm's length pricing methodology is applied to third party dealings. This is necessary to ensure that the arm's length price for an internal dealing does not imply income in excess of that derived by the entity from a related dealing with a third party.

5.27 The profit split method may appropriately be adapted and applied to split an overall profit, made by an entity as a result of a particular series of activities, between a head office and PE which have each contributed to the derivation of that profit. Residual and contribution profit split techniques may be used depending on the circumstances. A functional analysis of the MNE will provide the basis for determining the economic value that the head office and PE have contributed to deriving the overall profit. This will in turn provide the basis to determine the proportions in which that profit is split between the head office and PE, thus effecting an appropriate arm's length allocation of income and expenditure for attribution rule purposes.

Step 3: Apply the most appropriate methodology and determine the arm's length outcome

Data Collection / Organisation	Action / Evaluation
Review segment accounts, adjust if needed, and assess relevance to the PE as defined. Fully specify the underlying economic model Refine, examine and organise the data on comparable dealings, adjusting the data where necessary	Comparability analysis Assess reliability Decide on the arm's length outcome, applying more than one method if necessary

5.28 A comparability analysis must pay careful attention to the outcome of the functional analysis, the specific terms of any contractual arrangements (in global trading these might include volume, rights to modify contract, contingencies, length of contract, settlement date and place, principal, currency, specified indices, jurisdiction and dispute resolution), risks (including market, liquidity, hedging, credit and exchange) and the relevant economic conditions.

Step 4: Implement support process and install review process

Data Collection / Organisation	Action / Evaluation
Collect data re above processes Monitor changes in nature of PE business and actual / implied dealings Monitor comparables	Process to be documented and a system put in place to support on-going application of attribution methodology in the future Establish procedures to ensure that material changes are noted and addressed

Documentation

5.29 It is considered that taxpayers who carry on business through a PE are required to keep records which evidence the basis upon which, for tax purposes, income, expenditure, assets, liabilities and capital are allocated and profits attributed to the PE.[86]

5.30 In reviewing the appropriateness, in terms of the business profits article and section 136AE, of a taxpayer's calculations of PE income and expenditure / profit, we will seek to rely as much as possible on documentation that has been created by the taxpayer in the ordinary course of conducting its business. Where separate accounts are maintained for the PE and these reflect the underlying reality behind the transactions the amounts recorded in the accounts will be the starting point when we evaluate whether a taxpayer's allocation of income, expenditure, assets, liabilities and capital to a PE and the resulting attributable profit is appropriate.[87]

5.31 We expect taxpayers to keep documentation to show that the process used for calculating PE income, expenditure and profit properly addresses the considerations in the business profits article and section 136AE, including the arm's length principle, and that their tax returns have been prepared on that basis.

5.32 Where taxpayers have not used arm's length amounts in the ordinary course of conducting dealings between a PE and other parts of the enterprise, or in recording those dealings for accounting or commercial purposes, adjustments needed to reach the correct attribution result for tax purposes will need to be made at the time of preparing their tax returns.

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[86] See section 262A

[87] In this regard, it is also noted that the Ralph Report has recommended that branches be required to keep financial accounts for taxation purposes – Recommendation 22.11(c).

5.33 Ideally, the process for determining PE income, expenditure, assets, liabilities and capital, and profit should be modelled along the lines described above.[88] The tables for the steps provide an indication of the information required and the documentation that should be prepared and retained. A very important part of this documentation is the analysis undertaken of significant economic functions, the assets utilised, and the risks associated with the business activities.

5.34 Our views on the documentation requirements for demonstrating compliance with the arm's length principle in dealings between separate entities are addressed in Taxation Ruling TR 98/11. To the extent that the analysis and processes involved in the selection and application of internationally accepted methodologies used to apply the arm's length principle apply to dealings within a single entity, the documentation requirements discussed in that Ruling are relevant.

Examples

Example 1: Functional Analysis - Installation Project

5.35 Supernet Company Limited (SCL) is a multinational incorporated in the United States of America, with sales in the current year of A$36.9 million, and specialising in the design, construction and testing of telecommunication networks. In addition to a head office organisation, SCL has a separate technical division located in the USA. SCL also has wholly owned construction subsidiaries in many of the countries in which it works. These subsidiaries specialise in high technology projects and compete actively with other contractors for work, including contracts offered by SCL.

5.36 SCL wins a contract to construct a global microdigital telecommunications network on behalf of a third party. The telecommunication network will be situated in four countries – USA, Australia, Germany and Korea - with similar equipment being installed in each country, all linked by new microwave technology. SCL will be paid a total of A$10M for the successful completion of the project on time and to stated performance standards. Of this amount, payments totalling A$2.2 million are allocated under the contract for the completion of the Australian link in the network.

5.37 The completion of this global contract will take three years, with the Australian installation being the first and taking approximately twelve months to complete. A specific department in the Technical Division of SCL has been specifically created to oversee the development, installation and testing of this infrastructure project.

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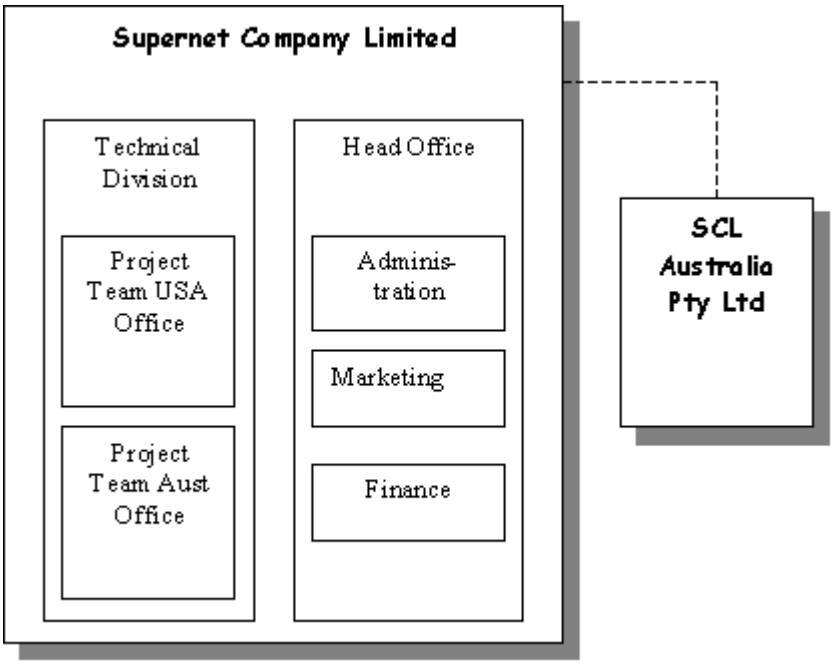
[88] Refer paragraphs 5.18 to 5.28

5.38 SCL puts the construction of the Australian installation out to tender. The tender by SCL Australia Pty Ltd (a subsidiary company) is competitive and is accepted by SCL. A contract is drawn up by SCL's lawyers defining the scope of the work and responsibilities of the parties as per the tender documents and specifying the agreed price (A$1.5 million). SCL's primary role will be to supervise the construction and test the installation of equipment situated in Australia.

5.39 SCL supervises the construction and installation of the equipment by establishing an office in rented facilities in a town near to the construction site. The office is staffed by a local manager and two office employees, all of whom are Australians and employed by SCL for the period of the project. Their role is to provide administrative support in Australia for the project, ensuring co-ordination of the work of SCL Australia's contractors and providing regular reports on progress to the Head Office. This includes payments of minor expenses and attention to compliance with Federal, State and Local Government requirements. The local office also provides local support for the small technical teams sent out on a regular monthly basis from SCL. The local office is linked directly to Head Office through the SCL computer systems, and has access to SCL administration systems. Working funds for the local office are provided on a regular basis by SCL by a transfer from the USA to an office account in a local bank.

5.40 During the testing period after construction it is recognised that Australian technical expertise is needed to take adequate account of the unique environmental conditions experienced in Australia. The local office staff is expanded by the manager to include two experienced and qualified engineers and a small laboratory with specialised technical equipment is installed. Since the Australian project is the first to be completed, the experience gained by these engineers in the testing phase may be valuable in the work to be done in the other three countries.

5.41 The above arrangements may be illustrated as follows:



5.42 An initial assessment of the functions performed by the SCL segments in USA and Australian is set out below.

Aspects of Functions, Assets and Risks

	Construction Phase	Testing Phase
Functions		
Winning head contract and tendering out	Predates project implementation	Predates project implementation
Continuing R&D	Assume all relevant R&D completed prior to contract –see Assets	Assume all relevant R&D completed prior to contract -see Assets
On going design work related to project	Technical Division USA and Project team USA office	Project team Australian office
Administration	Head Office and Project team Australian office	Head Office and Project team Australian office
Supervision of construction	Project team USA office and Australian office	Not applicable
Testing of equipment installed	Project team Australian office	Project team Australian office
Approval of SCL Aust subcontractors	Project team USA office and Australian office	Not applicable
Assets		
Technical know-how	Accessible by project team staff both in USA and Australia	Accessible by project team staff both in USA and Australia
Technical facilities	Technical Division USA and Project team USA office	Project team Australian office
Office facilities and equipment	Head Office and Project team Australian office	Head Office and Project team Australian office
Working capital	Both Project team USA office and Australian office have working capital provided by SCL treasury	Both Project team USA office and Australian office have working capital provided by SCL treasury
Risks		
Overall project risk	SCL as head contractor	SCL as head contractor
Supervision	Project team USA office and Australian office	Project team Australian office
Foreign exchange movements	SCL Treasury	SCL Treasury
Performance of technical systems and components	Technical Division USA and Project team USA office	Project team Australian office

5.43 SCL has a sufficient presence in Australia during both the construction and testing phases and a PE exists for the duration. The PE consist of the Project team's Australian office and the engineers and field staff that it supports while they perform supervisory activities in Australia. The term head office is used to embrace all aspects attributable to SCL's activities in USA.

5.44 The core activities carried on by SCL personnel in Australia and United States in relation to the project are manifest in the day to day technical and managerial oversight of the construction work carried out by SCL Australia and its agents and testing of the equipment installed. It is the kind of assistance that could be obtained from an engineering consultant and this would tend to indicate that a service provider model may be appropriate.

5.45 However, as the above assessments of functions, assets and risks reveals, there are some issues that could present difficulties in applying a service provider approach for attributing profits to the PE. Broadly, the assessment points to a change in the functions carried out and assets employed in the PE and head office as the project moves from construction to testing and completion. This implies that the value added by the PE in the latter phase is greater and therefore the attributable profits should increase (e.g., a higher mark-up on costs of the PE would apply). Whether this is a sound approach would depend on an examination of comparable services. It may be found that an engineering consultant would normally contract for the supervisory and testing functions for an all inclusive fee payable in instalments over the life of the project and the theoretical correct answer would involve an apportionment of the all inclusive value between PE and head office according to the relative contributions at each phase. In practice this may be the source of some uncertainty.

5.46 Another consideration for choosing and implementing a service provider approach that will be apparent from the above overview of functions, assets and risks is that the search for comparable may be affected by some important aspects of assets employed and risks present. Some assets (particularly know-how) are accessible by both the head office and PE at the one time and will not be attributable solely to one or the other. The assignment of the routine risks associated with technical supervision in this kind of situation is similar. The fact that during the construction phase technical division staff are moving between the PE and head office in the course of carrying out the supervisory activities would suggest that it does not make sense to assign the risk of human or system error between PE and head office. However, these factors would not necessarily prevent the service provider model being applied as the same situation could exist in independent international consultancy firms and an examination of a range of such cases may be instructive.

5.47 However, there is an additional risk factor presented by the contracting arrangement in this example: the overall project risk. Typically, the supervisory activities carried out by a head contractor to ensure successful completion are reliant on knowledge based risk management systems and networks as well as placement of skilled personnel on site or within reach. This combined with the fact that the head contractor's profit for its function as such would be expected to be different from that of someone who is providing services without the overall project risk.

5.48 The presence of overall project risk will tend to rule out a service provider approach unless on the facts it may be validly concluded that the risk rests solely with the head office. An argument that may be raised is that the Technical Division functions give rise to the PE and these should not be considered to include overall project risk, had SCL placed its Technical Division in a USA resident subsidiary, it could not have divested itself of the overall project risk. A contrary argument is that the legal implications of the choice of keeping functions within the one company or siting them in a separate company may be significant. Given the fact that the supervisory functions are sited in and carried on by SCL as head contractor it is difficult to avoid the conclusion that overall project risk attaches to the Technical Division functions and to the PE. If that is the correct conclusion, a joint venture model may be a more appropriate one to attribute the profits of SCL from the Australian installation to its PE. On the facts presented, the difference between the amount allocated to the Australian installation under the head contract ($2.2 million) and the tender price under the construction and installation contract ($1.5 million) could be a starting point for the profit calculation if those amounts are the arm's length values.

Example 2 - Calculating Segment Profits - Language School with foreign PE

5.49 An English language school, based in Sydney, provides tuition and generates learning materials and software. Some of the materials are consumed and the software is used in the delivery of courses at the School. Courses are also offered in a self-directed learning format and the materials and software for this are offered for sale on compact disk and via the Internet. These functions are supported by management - administration team.

5.50 The School expands by opening a branch in Singapore. It leases premises and facilities and locates several of its language teachers there. As an adjunct to presenting courses the teachers advertise and sell the self directed learning packages created in Sydney. In fact this proves very successful. The demand for software supplied over the Internet to customers in South East Asia increases

substantially. The Singapore branch also holds a small stock of materials and software to supply its customers who do not have Internet access.

5.51 Prior to the creation of the Singapore branch, the School's accounting system was a single product and cost centre. With the expansion of the business, management decides to organise the operations into a Language Program, a Distance Learning Centre and an Administration area. The Language Program consists of the Singapore and Sydney Language Teaching Centres. The Distance Learning Centre carries out the research and writing of packages and IT functions. Administration includes the current management and administration support.

5.52 Management is keen to track the financial performance of each department and the Singapore branch. Accordingly, they introduce 3 product centres and 4 cost centres:

Product

(1) Language Centre - Sydney

(2) Language Centre - Singapore

(3) Distance Learning Centre

Cost

(1) Language Centre - Sydney

(2) Language Centre - Singapore

(3) Distance Learning Centre

(4) Administration

5.53 Management authorises the heads of the Language Program and Distance Learning Centre to incur direct labour and supplies and running costs such as telephone and travel. In addition, with the opening of the language centre in Singapore, the head of the Language Program is given responsibility for spending on premises and equipment in Singapore and the School's advertising, the majority of which is to be directed to Asia. Administration retains responsibility for management, accounting and office salary and wages, administration supplies, occupancy costs of the Sydney premises, furniture and equipment (including computers) and the legal costs associated with the protection of copyright materials and software.

5.54 Under its new organisational structure the following accounting policies are introduced:

Revenues

- Course fees are income of the Language Program and subject to allocation between

Singapore and Sydney according to where the students paying the fees are enrolled.

- The proceeds of sale of materials and software whether by Internet or otherwise are income of the Distance Learning Centre.

Costs

- Costs (direct or indirect) incurred by a cost centre are to be allocated to that centre.
- Indirect costs incurred for the benefit of two or more cost centres are to be apportioned between the centres using an appropriate allocation key, e.g., segment incomes.

5.55 At the end of the first year from the date of the expansion, the following income and costs (according to cost centre responsibility) are extracted from the accounts:

Item	Language Centre Singapore	Language Centre Sydney	Distance Learning Centre Sydney	Administ-ration Sydney
Course fees	600	1000		
Sales of Materials and Software			700	
Total Income	600	1000	700	
Direct labour costs	300	500	300	
Salaries - Manager and Accountant				150
Wages - Office staff				130
Legal expenses re international copyright protection				25
Supplies, telephone, travel, acquired in Sing	20			
Supplies, telephone, travel, acquired in Syd		25	30	5
Occupancy costs - Sing	50			
Occupancy costs - Syd				145
Depreciation of equipment				25

Item	Language Centre Singapore	Language Centre Sydney	Distance Learning Centre Sydney	Administ -ration Sydney
Leasing of equipment and furniture	15			
Advertising incurred in Sing	85			
Advertising incurred in Syd		30		
Total Costs	470	555	330	480

5.56 The School's accountant, in accordance with the accounting policies, apportions the Administration overheads to the Language Program and Distance Learning Centre with the following results:

	Language centre – Singapore	Language Centre – Sydney	Distance Learning Centre Sydney	Consolid -ated
Income	**600**	**1000**	**700**	**2300**
Expenditure				
Direct labour	300	500	300	1100
Direct supplies, telephone, travel.	20	25	30	75
Occupancy costs	50	70	40	160
Depreciation		15	5	20
Leasing costs	15			15
Advertising	85	30		115
Allocation of Office staff- wages on hours used		30	20	50
Apportionment of remaining Admin overheads see note	78	130	92	300
Total Costs	**548**	**800**	**487**	**1835**
Profit	**52**	**200**	**213**	**465**

Note: Apportionment of Administration Overheads

Includes -	Salaries – Manager and Accountant	150
	Unallocated Office Staff wages	80
	Legal expenses	25
	Office supplies – admin	5
	Unallocated Occupancy Costs	35
	Unallocated Depreciation	5
Apportioned on basis of segment incomes		300

5.57 The Manager discusses these figures with the heads of the departments. Taken at face value the results for the Singapore Language Centre appear disappointing. However, the head of the Language Program argues that the Singapore expansion has been a financial success as it has generated substantial additional revenue both from language courses and distance learning. In the ensuing debate the following issues are identified:

- The advertising expenditure incurred in Singapore and Sydney is for newspaper advertisements and mailouts in relation to the language program courses offered in each place. The advertising includes the Internet address of the School, which has provided a ready reference to the Home Page and information about the products offered on the Internet by the Service Centre. Should the Distance Learning Centre be charged for the advertising benefit?
- In relation to sales of material and software facilitated by Language teachers, in particular those made to Singapore students out of the stock maintained in the Singapore Language Centre, should part of the profit be attributed to the Language Centres? How?
- The copyright protected software material is developed by the Distance Learning Centre and utilised directly in Singapore. Should the Distance Learning Centre charge for the use of copyright material in the Language Centres, e.g., by payment of a site licence or royalty based on the number of students?

5.58 In relation to each of these questions the accountant advises:

- The Distance Learning Centre should share the advertising costs. In order to apportion the expenditure a sample survey is conducted to determine what proportion of purchasers of distance learning materials became aware of the product via the newspaper ads and brochures. The following estimate is made of the advertising affected income, which is used to apportion the advertising costs.

Advertising Affected Income

	Total	Percent Affected	Amount
Asia - Distance			
Learning Packages			
Internet	$300	75%	$225
Direct	$150	80%	$120
Asia – Course Fees	$600	90%	$540
			$885
Australia – Distance			
Learning Packages			
Internet	$100	30%	$30
Direct	$150	40%	$60
Aust – Course fees	$1000	35%	$350
			$440

Apportionment - Singapore Advertising
$345/$885 x $85 = $33 to Distance Learning Centre

Apportionment of Australian Advertising
$90/$440 x $30 = $6 to Distance Learning Centre

- Under the internal arrangements the responsibility for accounting for the stock of shrink-wrapped materials sent to Singapore remains with the head of Distance Learning Centre who does not treat it as 'sold' until it is in fact sold to a customer. Accordingly, the Singapore Language Centre should be regarded as an agency and rewarded by a commission on the direct sales out of the Singapore stock. He advises that a fee of 10% of gross value of sales would be appropriate based on some broad comparables. This amounts to $15 (i.e., 10% of Asia direct sales of $150).
- The copyright is owned by the entity and not any segment of the entity. There is no basis for a defacto royalty between the Language Centres and the Distance Learning Centre. However, to the extent that the use by the Language Centres involves 'consumption' of materials (i.e., disks, manuals, etc) these should be

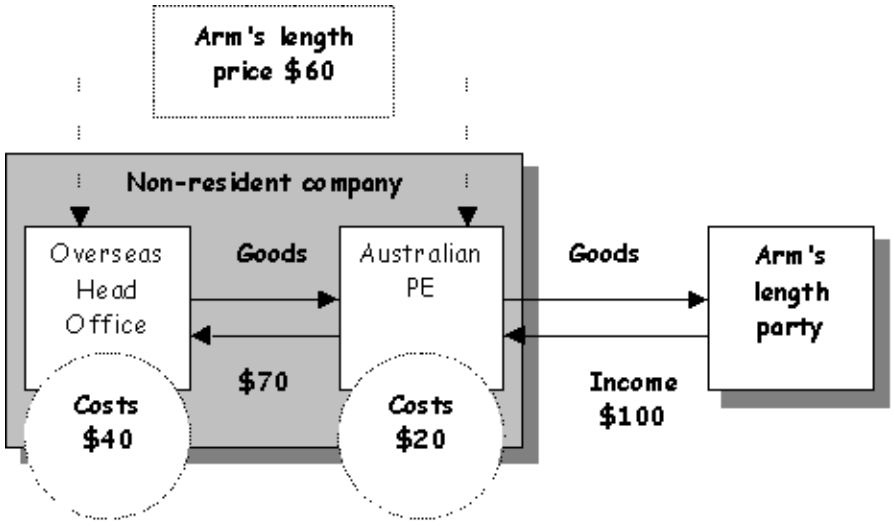
charged for on the same basis as if the transfer was to an external party. It is estimated that the selling value of these items is $10 of which $4 relates to Singapore and $6 to Sydney.

5.59 The Segment results are adjusted based on this advice - per table below. The information is provided to the School's tax agents for use in preparation of Australian and Singaporean tax returns.

	Language Centre-Singapore	Language Centre - Sydney	Distance Learning Centre	Consolidated
Profit - per above	**52**	**200**	**213**	**465**
Apportionment of Advertising Costs	33	6	(39)	0
Intersegment charge - Agency Commission	15		(15)	0
Intersegment Charge - materials	(4)	(6)	10	0
Adjusted Segment Profit	**96**	**200**	**169**	**465**

Example 3 - Use of accepted transfer pricing methodologies to allocate income and expenditure to PEs

5.60 Suppose that an enterprise derives $100 from selling goods to customers. Goods are manufactured to a partly finished state by an overseas head office at a cost of $40, imported into Australia and, after some additional manufacturing, sold by an Australian PE to arm's length parties for $100. The transfer price recorded in the enterprise's accounts (at the time of transfer) is $70. The Australian PE sells the goods to customers after additional manufacturing and selling costs of $20 are incurred. The enterprise has derived an overall net profit of $40, of which $10 has been allocated in its accounts to the Australian PE and $30 to the overseas head office. This example can be illustrated in the following diagram and tables:



Recording of dealings in goods in company's accounts:

	Entity accounts for external reporting	Internal (management) accounts - Australian PE	Internal (management) accounts - Overseas HO
Actual income	**$100**	**$100**	
Notional income			**$70**
Actual expenses	**$60**	**$20**	**$40**
Notional expenses		**$70**	
Profit	**$40**	**$10**	**$30**

Application of Article 7 and/or subsection 136AE(4) to reallocate the entity's income between HO and PE having regard to the arm's length price of the dealing in goods between HO and PE:

	Entity	Australia	Overseas
Actual income	**$100**	**$40**	**$60**
Actual expense	**$60**	**$20**	**$40**
Profit	**$40**	**$20**	**$20**

5.61 In this situation, the income derived from sale of the goods may be considered attributable to activities carried on through both the head office and the PE, and accordingly an allocation of parts of that income must be made to each.

5.62 In making this allocation, regard may be had to the accepted methodologies for applying the arm's length principle. A CUP, cost plus, resale price or other appropriate method may be used to test the

$70 price at which the foreign head office transferred the goods to the Australian PE against an arm's length amount. Whichever of the methods is most appropriate in the circumstances should be used to determine an arm's length price of the manufactured goods in comparable circumstances. If, for example, this price is found to be $60, then this will be taken into account under the business profits article or subsections 136AE(4) and (7), and may provide a basis for a $10 increase in the Australian PE's share of the enterprise's income derived from the sale of the goods in Australia.

5.63 Alternatively, if comparables on price or profit margin cannot be identified, a profit split method would appear suited to this situation. Under this method, the overall profit of $40 is split between the head office and branch based upon the relative value of their respective contributions to deriving it, as ascertained through a functional analysis of the enterprises. This might ascertain the arm's length return to the Australian PE for its manufacturing, marketing and distribution functions, compared with the manufacturing functions of the foreign head office. If, as a result, the arm's length return for the branch's functions is ascertained to be a net profit of $20, this will necessitate an increase in the Australian PE's share of the enterprise's actual profit to $20. In other words, the $70 transfer price shown in the enterprise's accounts will be adjusted downwards by $10 to effect an allocation of $60 income to the foreign head office and $40 to the Australian PE.

5.64 This example assumes that the functional analysis of the enterprise establishes that the PE acts on its own behalf in performing the relevant selling activities. If the analysis were to establish that the PE, viewed as a separate entity, in substance acts merely as a selling agent for the head office, and there is evidence that an arm's length agent's fee in such circumstances is a reimbursement of costs plus a margin of 5% of gross income, then regard would be had to an arm's length amount of only $25 in allocating part of the $100 income to the PE.

5.65 A potential problem with having regard to accepted arm's length pricing methodologies for allocation of income between a PE and head office, is that in some circumstances, the income to be allocated may be insufficient to justify the internal transfer price. For instance assume the goods in the example had been accidentally damaged while held by the PE and not covered by insurance. The PE is only able to sell them for $40 because of the damage. It is no longer possible to allocate $60 to the head office because this figure exceeds the actual income (the sale price). What amount is allocated to the head office would depend on the circumstances but again assuming that $60 reflects an appropriate transfer price at the time the goods are transferred between head office and PE may be the whole of the $40 sale price. Such an allocation of income and related

expenditure would leave the PE with a loss of $20 and the head office with a profit of $0.

5.66 It follows from the ATO view that the allocation of income and expenditure will not produce the same outcome as the arm's length separate enterprise principle whenever the ultimate sale price is less than the transfer price.

5.67 The case where the ultimate sale price is less than the transfer price is likely to be rare in practice. Moreover, the principles concerning aggregation of transactions[89] will often mean that the effect of individual transactions where the ultimate sale price is less than the transfer price is outweighed by other transactions where the sale price exceeds the transfer price. Where aggregation is appropriate under arm's length principles, the ATO considers that the allocation of income and expenditure approach does not require disaggregation for the application of Australian domestic tax law.

Chapter 6 Application

Introduction

6.1 The previous chapters have set out the view that Australia's profit attribution rules work on amounts of actual income and expenditure under domestic law, and not notional amounts arising from intra-entity dealings between head office and PE. However, in seeking to allocate income and expenditure, notional transfer prices calculated in accordance with the arm's length separate enterprise principle can be taken into account and, in most cases, produce the same profit outcomes as would direct allocations. The discussion of methodology has emphasised the need to characterise the PE and to use the arm's length separate enterprise principle in allocating the income and expenditure.

6.2 When seeking to apply this analysis in actual situations, significant issues arise which are not readily answered by the method of analysis required under Australian law. This chapter seeks to analyse a number of problems of this kind and suggest solutions to produce practical outcomes. As with transfer pricing between associated enterprises, it is necessary to arrive at a result.[90]

6.3 One source of issues is that the enterprise is likely to maintain its records on a whole of enterprise and segment basis but not contain sufficient information to allow application of the allocation process set out in Australian law. The discussion of trading stock below raises this kind of issue.

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89 See Taxation Ruling TR 97/20 paragraphs 2.73 to 2.82

90 See Taxation Ruling TR 97/20 paragraphs 3.88 and 3.89

6.4 Another source of issues is that, unlike separate enterprises, the PE and head office will not enter into actual transactions which require a choice by the enterprises of the form of transaction. Any choice of notional transaction can only be reflected in the financial records of the enterprise – there will not be contracts or any of the usual documentation surrounding actual transactions. While the OECD Transfer Pricing Guidelines contemplate limited circumstances where actual transactions between separate enterprises can be disregarded, it is not clear that the same constraints apply to the accounting records of a PE. The OECD Commentary on Article 7 gives considerable weight to the accounting records of the PE in determining PE profits. It recognises, however, that 'agreements' implicit in the accounts are not legally binding contracts and need not be respected if they are not prepared symmetrically with the head office accounts or if they do not reflect the functions performed by the different parts of the enterprise.[91] This is a broader mandate to reconstruct transactions than as between separate enterprises. The treatment of capital expenditure illustrates the kinds of problem encountered here.

6.5 The topic of intra-entity services has been included to deal with the issue whether such services should be allocated at cost or cost plus / minus a factor to align their value with the arm's length prices of the same or similar services provided between independent entities. The established OECD position was that, in typical circumstances, the services were related to general management activity and accordingly the price at which an independent service provider would supply is not really applicable.

6.6 Capital allocation is an issue for PEs generally and one of several issues of special importance to the finance industry. Capital allocation has been the subject of considerable attention at the OECD; refer to the 1984 Report[92] and recognition in the 1994 Report[93] that those special principles still stood. The issue has also received attention recently in the Ralph Report. The issue is discussed in more detail in paragraphs 6.38 to 6.62.

6.7 Finally, in some cases domestic law and tax treaties deem PEs to exist in such a way that the arm's length separate enterprise principle seems to require modification if it is to give effect to the apparent intention of the deeming, that is, to ensure that profits are taxable in the country where the PE is deemed to exist. The chapter concludes with some discussion of these problems.

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91 OECD Commentary, Article 7, paragraphs 12 and 12.1

92 OECD, *Transfer Pricing and Multinational Enterprises: Three Taxation Issues*, 1984.

93 OECD, *Model Taxation Convention: Attribution of Income of Permanent Establishments*; Issues in International Taxation No.5, 1994.

Trading stock

6.8 The principles for attribution apply in the context of annual taxation accounting under Australian tax law for calculation of taxable income or loss. Issues of timing the derivation of income, incurring of expenditure and realisation of profit and loss can be significant for correct attribution where the business activities carried on by an entity at or through a PE extend beyond a single accounting period (year of income). This is the normal situation encountered in relation to continuing businesses.

6.9 The treatment of trading stock is a good way to illustrate the effect, in the context of internal dealings, of critical events crystallising income and expenditure or profit and loss where they span year end.

6.10 Under section 70-35 (ITAA 1997), the excess of the value of trading stock of the business on hand at the end of the year of income over the value at the start is included in assessable income. Correspondingly, a taxpayer may deduct any excess of the value at the beginning over the value at the end.

6.11 The value of trading stock on hand at the end of the year of income is either its cost, market selling value or its replacement cost at the election of the taxpayer. In some circumstances, a different valuation method may be adopted.[94] The value of trading stock at the start of the year of income is the same amount as its value at the end of the previous income year.[95]

6.12 Broadly speaking, the accounting for trading stock on hand assumes that one can track when particular stock is acquired, its value and when it is disposed of, by sale or other means. As a matter of practice, transactions may be aggregated and the movements and, thus value of stock, addressed by a general rule such as FIFO or average cost, being the generally accepted methods under Australian tax law.

6.13 If an entity carries on business through a PE, trading stock on hand may be transferred internally prior to sale. For instance, the PE may carry on a wholesaling function. It acquires stock from arm's length suppliers then transfers it to a retailing segment of the entity in other countries. Under separate accounts for the PE, items of stock may be treated as no longer on hand at the point of transfer and profit then recognised having regard to (say) an internal transfer price. Even if the internal transfer price reflects the arm's length value of the goods, this will not correctly allocate profits between the PE and the other segments if the stock remains on hand in the retail segments at year end. Amongst other things, the extent and direction of the inaccuracy will depend upon the basis of valuation that has been

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[94] Section 70-45 (ITAA 1997)
[95] Section 70-40 (ITAA 1997)

adopted for taxation purposes. The use of values other than market value are likely to present problems in achieving the correct allocation of profit for the income year.

6.14 Assume for the purposes of illustration that in March 1997 the Australian wholesaling segment of a United States firm acquires widgets from third party manufacturers for $100 per unit. It carries out some processing and incurs additional costs of $10 per unit. In May 1997 it 'sells' to the entity's retailing segment in the United States at $130 per unit. The widgets remain on hand at 30 June 1997. The entity values its stock on hand at cost. The retail segment sells the units in July 1997 for $150 per unit.

6.15 The following basic accounts may be constructed:

Consolidated Entity Accounts		
Trading Account	1997	1998
Sales	nil	150
Stock at start	nil	110
Purchases	100	nil
Processing / Freight	10	nil
	110	110
	110	nil
Stock at end (cost)	110	nil
Cost of sales	nil	110
Gross Profit	**nil**	**40**

Segment Accounts		
Trading Accounts (1997)		
	Wholesale	Retail
Sales	130	nil
Stock at start	nil	nil
Purchases	100	130
Processing / Freight	10	nil
Stock at end (cost)	nil	130
Cost of sales	110	nil
Profit	**20**	**nil**

Trading Accounts (1998)		
	Wholesale	Retail
Sales	nil	150
Stock at start	nil	130
Purchases	nil	nil
Processing / Freight	nil	nil
Stock at end (cost)	nil	nil
Cost of sales	nil	130
Profit	**nil**	**20**

6.16 We can see from this simple scenario that no profit has been realised at the end of the 1997 income year with respect to these particular goods. The expenditure incurred during the income year ($110 per unit) is offset by an increase in the value of trading stock on hand ($110). On an entity basis there is no profit realised and none to be attributed either to the PE in Australia or to the retail activities elsewhere. In contrast, the accounts for the wholesaling segment will show a profit of $20 per unit at this point. This is probably entirely correct for internal management purposes as the wholesaling function has been completed. For performance monitoring purposes, the segment accounts anticipate the PE share of the profits realisable by the entity when the retailer sells into the market.

6.17 If the entity elects to adopt market value for trading stock on hand, the realisable profit for the entity from the sale of the units is brought forward to the 1997 year of income (not a particularly likely scenario in normal circumstances). Segment accounts prepared on the basis of an arm's length internal transfer price should reflect consistent timing and may be a proper basis for the attribution of profits. However, replacement cost or other basis of valuation elected for tax purposes could present timing problems identified in the cost price example above.

6.18 In this simple case, there is an apparent conflict between the allocation process required by Australian law (which will only recognise income for head office and PE in the second year) and a strict application of the arm's length separate enterprise principle which would seem to require recognition of the wholesale profit in the first year and the retail profit in the second.

6.19 There are, however, practical problems in the way of treating all profit as arising in the second year. Where the stock being moved between PE and head office is raw material or components for use in a manufacturing process at the head office and the head office is drawing similar materials or components from all over the world, it becomes practically impossible to trace the particular inputs drawn from one PE into the sale of the finished product. Indeed, even in the case of the transfer of finished goods between head office and PE, tracing becomes difficult in many cases, such as where the countries involved use different accounting and tax conventions for trading stock (e.g., one uses FIFO and the other LIFO). As a result, it may be necessary to fall back on the accounts and account for income and/or expenditure on the basis of the transfers in the accounts and not the actual revenue or expenditure involving third parties. The above solution reflects the practical problems. The Ralph Report recommends that law changes in appropriate circumstances to permit the separate entity treatment start with the supply or acquisition of

trading stock.[96] Pending possible clarification through implementation of these recommendations, where these kinds of problems arise, the practice will be to accept the position reflected by accounts prepared on a separate entity basis, on the proviso that they have been properly prepared and the attribution outcomes are the best estimate of PE profits that can be made in the circumstances.

Asset allocations and capital allowances

6.20 Where stock is being transferred between head office and PE, there is usually little ambiguity in the structure of the notional transactions used for the arm's length separate enterprise principle. One part of the enterprise is treated as selling to the other part, which then actually sells to a third party. Outside such simple cases, the interpretation of the transfers is often not so obvious. For example, if a head office transfers capital equipment to a PE, which uses it in its business, is the transaction to be treated as a sale, a lease or something else? The Canadian case Cudd Pressure Control Inc[97] is instructive. There, a non resident company provided its own equipment for carrying out services on an offshore drilling rig owned by a Canadian resident. The carrying out of the services in question meant that the non-resident company had a PE in Canada. In calculating the profits of the PE, notional rent was deducted with respect to the use of the equipment at the place of the PE activities. The non-resident argued that if the PE was an independent enterprise, it would have rented the equipment from the head office. The judge at first instance (Tax Court of Canada), decided that in the circumstances the proper method of allocating a cost for the use of the equipment was to adopt the capital cost allowance provided under the Canadian tax law. The Federal Court of Appeal confirmed the decision essentially on the ground that the judge was correct to find that a third party would not have agreed to rent the equipment.

6.21 International transactions involving tangible and physical goods are so varied and complex, even where involving independent parties[98], that it is not possible to intuitively characterise transactions as sales or leases. Even if the accounts of the PE show a charge in relation to the equipment, it may not be clear whether that charge is notional rent or depreciation (with or without interest). *Cudd Pressure Control Inc* is indicative of the difficulty faced in seeking to characterise the use of an asset under the independent entity arm's length assumption.

6.22 The recognition of a notional transaction based on a physical transfer raises issues of whether the deductions for various capital

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96 See Recommendation 22-11(a)

97 See notes 32 and 33

98 See Cross Border Leasing Ruling – Taxation Ruling TR 98/21

allowances under domestic law are relevant and also whether the approach taken can achieve a proper result in terms of consistency across tax jurisdictions. There are difficulties in applying the allocation of deductions and the arm's length separate enterprise principle in tandem. Where the PE is in Australia, under domestic law various capital allowances will be available as the PE is using the capital equipment to earn assessable income. If the notional transaction is constructed as a lease, then there would be rent paid by the PE to the head office. If domestic law were applied along with the arm's length separate enterprise principle to this notional rent it would be deductible to the PE and for the head office subject to royalty withholding tax and exempt so that no depreciation deductions would arise (as those deductions now relate to exempt income). However, it is not possible to apply Australian tax to the transaction in this way – it is necessary to work with the depreciation that is in fact available under Australian law.

6.23 Looking to the allocation of income to solve the problem will not work. The allocation will, on the analysis given above, utilise the arm's length rent to allocate the income. However, if income derived from transactions entered into by the PE is sourced to the head office on the rent basis, this effectively gives a deduction to the PE for the rent (because Australian source income is reduced by the amount of rent) while at the same time leaving the depreciation deduction which Australian law gives to the PE – effectively a double deduction. It is not open to give the rent an Australian source in the hands of the head office and subject it to withholding tax because the conditions for levying withholding tax under domestic law would not be satisfied; the withholding tax law does not treat the head office as a separate taxpayer. Adjusting the rent to prevent doubling up of deductions does not represent a genuine allocation of income but would simply be an attempt to overcome the lack of reconciliation between the allocation approach and the arm's length separate enterprise approach.

6.24 Hence, the approach in such cases will need to be simply the allowance of capital deductions in accordance with Australian law. Although the basis of the capital allowances under Canadian law and the reasons for preferring a capital allowances approach in *Cudd Pressure Control Inc* may be different, the result reached appears the correct one for similar situations under Australian law.

Depreciation under Australian Law

6.25 It should be noted that in *Cudd Pressure Control Inc,* the approach for calculating the capital cost allowance was to adopt the market value of the equipment at the time it was brought into Canada and to deduct depreciation based on that value. This would not be acceptable under Australian taxation law.

6.26 Where the Australian PE of non-resident entity is the user of plant owned by the entity, a depreciation deduction is available under Division 42 in determining the attributable profits of the Australian PE from the time the plant is used to produce assessable income.

6.27 Subsection 42-25(1) provides that the depreciation deduction available is based on the cost of the plant to the taxpayer, with cost of the plant being established under section 42-65. Often, this will equate to the original (or historical) cost of the plant. Where the diminishing value method is used for the purpose of calculating the allowable depreciation deduction (section 42-160), the original cost of the is written down in relation to the period of holding or use for non-assessable income purposes and this written down value forms the opening value of the unit of plant at the time use commences for assessable income purposes (section 42-175).

6.28 For example, a non-resident company, ForCo, owns an oilrig that is in Australian waters for a 9-month contract and constitutes an Australian PE. A variety of depreciable plant, including the oil rig, is used during the Australian operations of the PE. The units of plant, including the oil rig, are already owned by ForCo and are transferred to the Australian PE at the commencement of the Australian operations.

6.29 Depreciation is allowable under Division 42 in relation to ForCo's assessable income and should be taken into account in calculating the PE's profits. The original cost of each unit of plant, owned by ForCo prior to the establishment of the Australian PE, will be written down for the period of time from original acquisition of the plant by ForCo to the time when the plant was transferred to the Australian PE. This written down value forms the opening value of each unit of plant, for depreciation purposes of the Australian PE. In general, this position effectively distributes the actual cost of plant over the life of the plant and between PE and Head Office based on the particular periods of use. It eschews the idea of creating a charge on the profits of the PE based on the value of the plant at the point that it was transferred to the PE.

Services

6.30 Services are commonly provided intra-entity between separate segments, e.g., functions may be sited at the head office and performed for the benefit of the activities carried on at its PE. Sometimes these functions are a separate business generating income through the supply of the services to third parties in addition to the performance of activities for other businesses of the entity. In other instances, the functions do not generate income directly; they contribute to the other activities from which income is gained.

6.31 The OECD commentary assumes that intra entity services are commonly concerned with the general management of the enterprise and states that the appropriate course is to allocate the costs of providing the services as part of the treatment of general administrative expenses. The allocation between parts of the enterprise should be on an actual cost basis without mark-up for profit.[99]

6.32 While this may be the general 'rule' the OECD commentary recognises that where the services functions are substantial in the context of the entities operations, e.g., the same services are supplied to outside customers or the functional area is established to provide specific services and its costs represent a significant proportion of the costs of the enterprise, a mark-up on cost may be appropriate.[100]

6.33 In the separate entity context, the first issue, according to Taxation Ruling TR 1999/1, is whether services have been supplied. This is determined by identifying the benefit (specific benefits or general benefits from centralised services) that is provided and received in the circumstances. The benefit must be one that an arm's length party would be prepared to pay some amount. The substance of the arrangement is all important.

6.34 In the case of a supposed service between a head office and a PE, the same threshold issue exists. In economic terms, the question is whether there is a rendering of a service by one segment to the other. A dealing should not be found between different parts of an enterprise unless a "real and identifiable event" (e.g., the physical transfer of trading stock, actual provision of services or a change in the part of an enterprise utilising an asset) has transpired between them. A functional analysis should determine whether such an event should be taken into account as an interbranch dealing of economic significance and taken into account for the purposes of attributing profit.

6.35 The services ruling specifies that whether a direct or indirect method of charging is adopted, the method should be the best approximation of the arm's length consideration for the services concerned. There is some accommodation around this principle in the form of the administrative practice articulated for non-core services and *de minimis* cases.

6.36 It is accepted that the arm's length value of intra-entity services may be a sound way of attributing income, expenditure and profit between its head office and PE particularly where they are of the substantial kind identified in paragraphs 17.5 and 17.6 of the OECD Commentary. When it comes to establishing the arm's length

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[99] See paragraph 17.7 of the Commentary
[100] See paragraphs 17.5 and 17.6 of the Commentary

amount the same methodologies ('CUP' and 'cost plus') may be validly used as for pricing similar services between separate entities. Under a cost plus method, an appropriate mark up would be involved.

6.37 However, pending the outcome of the review of PE guidelines at the OECD and subject to future developments in Australian law, it is proposed to retain an allocation of costs approach for general management or administrative expenses costs even though, if such costs were incurred by a parent company for the benefit of the group, they would under OECD transfer pricing guidelines and Taxation Ruling TR 1999/1 be chargeable at an arm's length price. The rationale for this position is;

- a cost sharing / contribution approach is often an appropriate model for centralised administration, and
- it is expected that it will be more difficult in practice to find appropriate benchmarks for pricing general administrative functions.

Financial dealings and funding

Enterprises in General

6.38 A functional analysis may be expected to reveal the functions, assets and risks with respect of a PEs activities. However, it will not necessarily indicate how, in terms of equity and debt, the functions, assets and risks are funded. The enterprise's capital resources made up of contributed capital, accumulated profits and debt may form a single fund or treasury out of which its working and investment capital requirements, including those of the PE, are met. The history of the enterprise's capital raising might also reveal that the capital requirements for some activities have been provided for by specific injections of equity or debt so that the pattern of capital allocation across the enterprise's business activities and investments may vary significantly. Capital allocation is an important aspect of the attribution of the profits of a PE because it bears on the amount of the interest expense allocated to the PE and other parts of the enterprise. It is also essential to the construction of a PE balance sheet for the application of domestic regimes limiting the amount of interest expense allowable.

6.39 However, for PEs generally, the actual funding will not be determinative of the interest allocated and profits attributable for taxation purposes if it differs from that expected of a distinct and separate enterprise undertaking the same activities under the same or similar conditions; refer Article 7(2) of Australia's DTAs and similar requirement relevant under subsection 136AE(7). This will commonly rule out capital allocations to PEs made up entirely of debt

as, under normal arm's length commercial circumstances, a separate entity cannot operate without some equity. Where a PE is apparently funded entirely from equity, the position for attribution purposes is also likely to be different from that expected under the distinct and separate enterprise hypothesis. From an Australian perspective, the primary concern is to ensure that non-residents with PEs in Australia do not allocate too much debt and interest to the PE and that residents with PEs in other countries do not allocate insufficient debt and interest to the PE. In each scenario the profits sourced in Australia may be understated.

Financial Institutions

6.40 The capital allocation issue is particularly important for financial enterprises, especially banks. It is common practice for operations to be carried on via branches and the allocation of equity capital has the potential to impact significantly on the results of each branch. There are also other PE attribution issues of special importance to banks, namely interest on interbranch loans and allocation of profits from global trading.

6.41 Multinational banks carry on worldwide business via both subsidiary and branch networks. Banking subsidiaries are generally subject to prudential regulation in the country of incorporation which dictate minimum levels of equity funding (non-deductible) such as ordinary shareholders funds, retained earnings, etc. Foreign bank branch operations are not subject to capital adequacy regulation in the host country but may be subject to solvency requirements set out by host country banking regulation. Branch banking operations are used for a number of reasons related to the credit rating of the parent, cost of borrowing and flexibility of operation.

6.42 The full services and products provided by the multinational bank are rarely replicated by foreign branches which tend to specialise in particular activities such as foreign exchange trading, money market activities and cross-border dealings. The foreign branches could operate out of leased premises and be staffed predominantly with employees engaged locally with senior positions filled by staff seconded from the head office. Areas such as credit policy, market risk, human resources and accounting are often centralised within the head office, and foreign branches refer to these departments as and when that service is required.

6.43 Separate accounting records are maintained for each foreign branch as these are often required for home country regulatory reporting requirements and for management (profit) reporting purposes which treat each branch as a separate functional unit. Parallel reporting structures may also exist along business lines within the branch by which those business profit centres report to their

equivalents in head office. Transactions between various branches of the bank and head office are often recorded in branch accounts rates as though they were with third parties. This accounting method serves to generate financial accounts and profit measures which closely resemble those expected of a distinct and separate enterprise in accordance with Article 7(2) of the OECD Model Tax Convention and subsections 136AE(4&7).

Capital allocation for multinational banks

6.44 It is the ATO view that the distinct and separate enterprise hypothesis underlying Article 7(2) requires an allocation of equity funding in the branch in order to achieve a level of profit expected to be found in a distinct and separate entity, undertaking the same or similar activities, under the same or similar conditions. Further, the level of equity funding allocated to each branch should be based on the actual equity funding unique to that enterprise that gives rise to the actual credit rating and funding costs. This is consistent with paragraph 83 of the OECD 1984 Report that accepts that the proportion of capital to total assets in a branch should be much of the same order as the proportion for the bank as a whole. Given the reality of a fixed credit rating between branches of the same entity, the level of (non-deductible) equity funding in each branch could be expected to be consistent on a risk-adjusted basis. Such an approach would take into account the different functions performed, assets contributed, and risks assumed by each branch.

6.45 Risk-weighting assets in accordance with the *Basel Capital Adequacy Framework* are considered by the ATO to be the most appropriate base for allocating the capital of an enterprise to its branches, since the framework is based on an international standard specifically designed to calculate appropriate levels of capital for individual banks operating in a global market. Risk-weighted assets calculated by the head office under the rules of its prudential regulator will be acceptable. The reliance placed by these prudential regulations on functions, determined by the bank's level of risk and assets, closely aligns the process with the arm's length requirements of the OECD Model Convention. Some banking activities involving greater risks will thus require more capital than other activities, hence the business of a branch may proportionately require more or less capital than the bank as a whole. Other methods for allocating a proportion of the capital of the enterprise may be considered justified where the bank can provide evidence demonstrating results consistent with the distinct and separate enterprise hypothesis in Article 7(2).

6.46 It is expected that the assets used in the risk-weighting process of the branch will mirror the assets reflected in the branch management accounts. Assets booked offshore may first need to be

added to the branch accounts if a functional analysis indicates the correct allocation of those assets is the Australian branch. In such circumstances, the risk-weighted assets of the branch and its level of equity funding will also be correspondingly adjusted.

6.47 When a bank engages in global trading activities, it is possible that several bank branches will control the global book during each day. In such instances, the capital attributable to that book, calculated according to risk-weighted assets of the book, should be split between those branches involved in the same proportion as the book profit allocation.

Example - Capital allocation to bank branch

6.48 The following example, based on a case where all the equity is allocated on a risk-weighted approach, illustrates the capital to be allocated to the bank branch:

Portion of equity funding recorded in accounts of entity	$100m
Average interest free equity recorded in Australian branch accounts for the year	$1m
Funding cost of third party borrowing's in Australia	$90m
Funding cost of interbranch borrowing	$9m
Yearly average risk-weighted assets of Australian branch (on & off balance sheet)	$750m
Yearly average risk-weighted assets of entity	$7,500m
Yearly average debt level of branch	$900m

6.49 Required branch capital is determined as follows:

Risk-weighted assets of Australian branch / Risk-weighted assets of entity x 'Equity' funding of entity

= $750m / $7,500m x $100m

= $10m

6.50 Shortfall or excess of branch capital is calculated by:

Average branch interest free equity minus required branch capital

= $1m - $10m = $9m shortfall

6.51 Branch funding adjustment is as follows:

Amount claimed = funding cost of (a) third party borrowings in Australia and (b) interbranch borrowings

= $90m + $9m

= $99m

Amount allowable = Average branch debt / Average branch debt + branch shortfall x total funding cost of branch

= [$900m / $900 + $9m] x [$90m + $9m]

= $98.01m

Therefore the adjustment = $99m - $98.01m

= $990,000 (increased taxable income)

Interbranch lending

6.52 The ATO does not recognise deductions for internal debts and receivables in relation to PEs of non-banks, consistent with paragraph 18.3 of the OECD Commentary on Article 7. However, "special considerations" apply to payments of interest made by different parts of a financial enterprise to each other (as distinct from capital allotted to them), as stated in paragraph 19 of the OECD Commentary on Article 7. In MNE banks, funds may be transferred internally from one branch to another with such transfers being characterised and recorded in the bank's accounts as loans, even though in a legal sense, an entity cannot lend to itself. The appropriate treatment of such interbranch loans, in cases falling outside of Part IIIB, is likely to vary depending upon the most appropriate structural analogue used in constructing an economic model of the PE (see Chapter 1). Selection of the most appropriate structural analogue would have regard to the degree of integration of the bank's funds raising activities which can be perceived as lying on a spectrum with the simpler and least integrated cases at one end and the most complex and integrated at the other end.

6.53 For example, at one end of the spectrum where interbranch loans are:

- infrequent during the course of the year
- of low value relative to the branches total borrowing needs (eg. where the bulk of the PEs borrowing needs are met in the local market); and
- broadly follow standard terms and conditions;

appropriate structural analogue for the PE may resemble that of a wholesale transaction between a bank and third parties. In such cases, interbranch loans may be recognised in determining the profits of the PE. The terms and conditions of such interbranch loans (e.g., principal, term of the loan, interest (discount) rate, currency, respective rights of the parties in the event of default, etc.) may need to be closely scrutinised to determine whether they are comparable to loans between independent banks dealing at arm's length and acting in their own self interest. For example, comparability adjustments may need to be made to account for the absence of credit risk on internal dealings within a MNE bank when compared with dealings between independent banks.

6.54 At the other end of the spectrum, where interbranch loans are frequent or form a substantial part of the PEs borrowing needs, or where the funds raising activities of the bank as a whole are very integrated, the most appropriate structural analogue for the PE and the rest of the enterprise of which it forms a part may be more akin to a joint venture. An example of very integrated funds raising activities would be where branches/business units with surplus funds transfer such funds to treasury (which may or may not be located in Australia), branches/business units with a funding deficit borrow funds from treasury, interbranch flows of funds between branches/business units and treasury are netted in treasury, and treasury undertakes market operations depending on the overall deficit or surplus funding position of the bank as a whole.

6.55 Funds raised by MNE banks are often from a variety of sources with varying interest rates, currencies and maturities. Some funds may be interest free or have very low interest rates, whilst others have high interest rates (e.g., subordinated debt qualifying as Tier 2 capital). Where the bank's funds raising activities are very integrated it may be inappropriate, in determining the profits of the PE, to recognise interbranch loans based on comparables selected from transactions between independent banks dealing at arm's length. In such cases, it may be more appropriate to use a blended rate to reflect the proportions of the MNE bank's funding at different interest rates, currencies and maturates in order to arrive at an arm's length interest expense for the PE in relation to any internal borrowings. Paragraph 24 of the OECD Commentary to Article 7 notes that there may be cases where the affairs of the PE are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts.

Global Trading

Example - Australian bank with foreign branches

6.56 ABC is an Australian bank carries on a financial intermediary business in Australia and in a number of foreign countries via a branch network.

6.57 Except for certain functions (e.g., credit policy, market risk, human resources and accounting) that are centralised in head office, the bank's branches at major centres in Australia offer a full range of bank services and products.

6.58 In contrast ABC's foreign branch network has more limited functions; the services/products are limited to international transactions such as foreign exchange trading, money market activities and cross-border dealings. The foreign branch operations are conducted in accordance with regulations laid down by the home country authorities such as the central bank or Finance Ministry.

6.59 The products transacted by the bank's branches are handled by each branch in one of the following ways:

(a) *separate book* – each branch manages its own position although one branch may transact with another branch, e.g., foreign exchange trading;

(b) *centralised book* – a centralised book system is maintained by the head office or at a foreign branch for some products. The location of the book depends on the product and business factors such as location of skilled staff, location of liquid and deep financial markets (both for the "traded" financial product and related hedge transactions), customer base and competition. All branches may enter into trades such as a purchase or a sale with that book. Overall management of the book rests with host branch although, in some cases, certain staff at other branches may be granted limited trading and risk management authority;

(c) *global book* – the book is passed between each foreign centre with that centre having responsibility for managing all open positions during the period it has control of the book.

6.60 Separate accounting records are maintained for the Australian branches and each foreign branch as these are required for regulatory reporting requirements in Australia and overseas. Transactions between various branches of the bank including loans are recorded similarly to transactions with third parties. Each branch is conducted as a separate functional unit for management reporting purposes

although different products may have a separate product reporting line for control purposes.

6.61 In the circumstances presented in this example, the foreign branches would be treated as PE's with income and costs determined from the mix of transactions entered into by each branch. Functional analysis is used to test the functions, assets utilised and risks assumed by each branch; and in particular, to identify the (cost free) capital needed by each branch, to test the allocation of fixed costs to branches and to product types within branches, and the contributions made by each branch and risks assumed in global trading activities.

6.62 The three trading concepts described above are merely examples of the various forms of global trading models and the ways in which trading and risk management activities may be structured. In reality, most trading structures can be represented along a continuum with the "separate book" at one end and the "global book" at the other end. The "centralised book" concept may be found somewhere in the middle of the continuum.

6.63 For products traded under the *separate book* concept, the income of the branch is determined by the transactions that are recorded in the accounts of the branch. Where the transactions are between branches, the rates used are determined at arm's length. The relevant economic model here is that of an independent trader.

6.64 Under the *centralised book* concept, all of the income is recorded in the accounts conducted by the head office (or the centralised location if this is not the head office), while staff costs are carried by the branch where the staff are employed. Under this scenario, each foreign branch acts as a broker bringing a transaction to the book, while the head office dealers manage the overall exposure. The dealer prices the transaction for the foreign branch and, subject to customer acceptance and financial market conditions, the foreign branch staff may add value to the dealer's quoted price by negotiating a better price for the transaction from its customers. In such situations the foreign branch has added profit for the banking enterprise generally and the foreign branch specifically. However, from a risk management/proprietary trading perspective, the overall gain/loss from the transaction is dependent upon the skills of the dealer. The foreign branch will not share in the gains or losses arising from the management of the book (unless limited trading authority exists at the foreign branch) but needs to be compensated on an arm's length commission basis for the transactions that they bring to the book (including added value where applicable). The circumstances here are akin to an agency relationship.

6.65 In relation to trading under the *global book* concept, the book is maintained in one centre, but the open position at close of trade in one country is passed to the next country. Traders in that country will

bring trades to the book as well as managing the opening position. Although there is some integration of functions resulting from the passing of open positions between trading locations, further integration arises due to such factors as the passing of position reports, market information and expectations/opinions between trading locations. In such integrated situations, it is often difficult to determine the contributions made by each trading location. Each centre contributes to the gain or loss derived from the book and so should share in the net gain or loss after all direct costs have been deducted. The basis for allocating the gain or loss will need to factor in the contributions made by each centre and the risks assumed. The model applying here is that of a joint venture relationship.

Deemed PEs

6.66 The basic concept of a PE is "a place at or through which the person carries on any business"[101] or "a fixed place of business through which the business of an enterprise is wholly or partly carried on"[102]. Both domestic law and treaties add to this basic concept a number of specific situations in which a PE exists, including where activities of a third party constitute the PE. In cases of such deemed PEs, issues arise of separating the profits of the third party and the PE and of applying the separate enterprise arm's length principle.

6.67 For example, an agent with power to contract is treated as a PE of the enterprise in certain situations.[103] The enterprise will be earning income through the activities of the agent and paying the agent for its services. Under the separate enterprise arm's length principle it could be argued that the PE makes no profit.

6.68 Using this argument where the agent is not related to the enterprise,[104] the activities of the agent would be rewarded by an arm's length price. As the agent's activities constitute the PE, it is said to follow that the revenue that can be attributed is the amount equivalent to the agent's fee because this is all that an independent party would, in fact, have received for the activities carried on by the enterprise in the jurisdiction. The PE would then obtain a deduction for the fee paid to the agent as the cost of using the agent with a nil tax result. If the agent is associated with the enterprise, then the agent may

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[101] Subsection 6(1)

[102] Article 5(1) Vietnamese Agreement

[103] See paragraphs (a), (e), (f) of the definition in subsection 6(1) and paragraphs 5(a) and 6 of Article 5 of the Vietnamese Agreement

[104] Where an agent is not an associate it may fall within the agent of independent status exception to the definition of permanent establishment (s 6(1) definition paragraph (e), Vietnam Agreement Article 5(6)) so that there is no case for attribution under the profit allocation rules. The exceptions require, however, more than that the agent is independent.

be rewarded with a less than arm's length price for its services. In this case the profit of the agent may be able to be adjusted to an arm's length amount using provisions relating to separate enterprises[105] with the same result for the profits of the PE where the agent is not related to the enterprise.

6.69 Alternatively in the latter case, an adjustment could be made to increase the revenue share of the PE under s 136AE(4) or Article 7(2) of the Vietnamese Agreement and to leave the below market value agent fee as it is (there is no obligation to make an adjustment under s 136AD or Article 9) with the result that the PE is taxed on the difference between the actual agency fee and the arm's length amount of the fee. The total profit taxed in the country of the PE would not change using this method, though the tax collected may differ due to the different tax position of the agent or PE (tax rates, carry-forward losses etc).

6.70 At first sight such a view seems to reduce the deemed agency PE to irrelevance since no additional tax base arises in the country of the PE. However, it is possible for an agency PE to be constituted by an employee of the enterprise, rather than be a separate business[106] and result in taxation of the enterprise even though there is no fixed place of business of the enterprise (e.g., travelling salespeople). In this case a separate enterprise carrying on the same activities as the PE would expect a fee in excess of the cost of employee wages in order for the enterprise to make a profit. Thus if an agency PE were constituted by employees of the enterprise, there would be a profit element to tax in addition to the arm's length amount (in this case wages) paid to the agent.

6.71 The outcome of this argument would be that an agency PE would only give rise to an attribution of a positive amount of profits either where the agent is an employee or where it is a related party which is paid less than the arm's length price for its services and no adjustment is made under the associated enterprises article.

6.72 The ATO does not accept this argument. As the OECD Commentary on Article 5 says in relation to the agency PE paragraph, "This provision intends to give that State the right to tax ..."[107] The limited right to tax which follows from the argument outlined above does not accord with this plain statement in the Commentary. Even when a person hires an independent business to perform agency or other activities on its behalf, it intends to make revenue from those activities over and above its costs. In the case of simple agency services such as selling consumer goods on commission, the profit of

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[105] Section 136AD or the associated enterprises article (Article 9) in Vietnamese Agreement

[106] OECD Model Commentary on Article 5 paragraph 32.

[107] Paragraph 31.

the enterprise on the agency activity will in many cases be determined by a mark up on the cost of the services. The extent of the mark up will depend on the particular circumstances of the case. The enterprise will usually have some head office costs of its own that may appropriately be allocated to the PE in agency cases just as in fixed place of business cases, e.g., the internal costs involved in dealing with the agent. The mark up will need, in the usual case, to leave a profit with the PE after deducting these costs.

6.73 In Australia where the calculation of taxable income of a PE proceeds by an allocation of revenue and expenses as discussed in Chapter 2,[108] the agency PE profit will be determined by allocating an appropriate share of the revenue from the transactions effected by the agent on behalf of the enterprise and deducting costs that are relevant to that revenue including the cost of the agency services and other local and head office costs related to the agency.

6.74 Similar principles will be applied to other special kinds of PEs under Australian law involving third parties. Australian domestic law and tax treaties contain a number of provisions creating PEs when one person processes goods on behalf of another. *Case F85*[109] demonstrates the kind of "cost toll" operation for which the provisions are designed. In that case a UK parent company (along with a number of unrelated foreign companies) had a direct investment in an Australian company that conducted manufacturing operations to the order of its shareholders. In the case of the UK shareholder company the products ordered were sold to the company which in turn onsold them to an Australian subsidiary which then sold them to unrelated parties in Australia. The pricing of the sales by the manufacturing company to the UK company and by the UK company to the Australian subsidiary were such that the UK company made the major part of the profit. It was held that there was no PE of the UK company in Australia under the 1946 UK Agreement and so the profit of the UK company could not be attributed to a PE.

6.75 The 1967 UK Agreement now provides in Article 4(8):

> Where an enterprise of one of the territories sells to a person in the other territory goods manufactured, assembled, processed, packed or distributed in the other territory by an industrial or commercial enterprise for, or at, or to the order of, that first-mentioned enterprise and -
>
> (a) either enterprise participates directly or indirectly in the management, control or capital of the other enterprise; or

[108] Refer paragraphs 2.11 to 2.14 and 2.19 to 2.21.
[109] (1955) 6 T.B.R.D.(NS) 483.

> (b) the same persons participate directly or indirectly in the management, control or capital of both enterprises,
>
> then for the purposes of this Agreement that first-mentioned enterprise shall be deemed to have a PE in the other territory and to carry on trade or business in the other territory through that PE.

6.76 Not only are the third party issues involved with this provision (what are the profits of the PE and what are the profits of the other parties involved), it does not say what the nature or the activities of the PE are which makes the separate enterprise arm's length principle difficult to apply. Nevertheless again it is clear that the provision was intended to establish a taxing right and effect should be given to that right. The method of doing so is suggested by the similar provisions in section 6 of the ITAA. The definition of PE there includes the following provision:

> (d) where the person is engaged in selling goods manufactured, assembled, processed, packed or distributed by another person for, or at or to the order of, the first-mentioned person and either of those persons participates in the management, control or capital of the other person or another person participates in the management, control or capital of both of those persons - the place where the goods are manufactured, assembled, processed, packed or distributed;

6.77 It is then provided in subsection 6(6) as follows:

> Where a place is, by virtue of paragraph (d) of the definition of "permanent establishment" in subsection (1), a permanent establishment of a person, the person shall, for the purposes of this Act, be deemed to be carrying on at or through that permanent establishment the business of selling the goods manufactured, assembled, processed, packed or distributed by the other person at the place that is that permanent establishment.

6.78 This attributes the selling activities and the associated profit to the country of the PE rather than to the country of the head office. It is considered that the treaty provision should be interpreted in the same light.

6.79 In more recent treaties this provision does not appear. The treaties do include another provision that is also present in the 1967 UK Agreement. Thus the Vietnamese Agreement provides in Article 5(5):

> A person acting in a Contracting State on behalf of an enterprise of the other Contracting State - other than an agent of an independent status to whom paragraph (6) applies - shall be deemed to be a permanent establishment of that enterprise in the first mentioned State if: …
>
> (b) in so acting, the person manufactures or processes in that State for the enterprise goods or merchandise belonging to that enterprise.

6.80 Paragraph (a) of this provision is the usual agency deemed PE. A similar provision also applies in the context of the domestic profit attribution rules under subsection 136AA(1) as follows:

> "permanent establishment", in relation to a taxpayer, means:
>
> (a) a place that is a permanent establishment of the taxpayer by virtue of the definition of "permanent establishment" in section 6; or
>
> (b) a place at which any property of the taxpayer is manufactured or processed for the taxpayer, whether by the taxpayer or another person;

6.81 Again a profit over and above that which would be made by a person doing the processing is clearly intended to be taxed in the state of the deemed PE by this provision. It would be possible in the case of the former type of provision because of its limitation to related parties and in the case of the latter type of provision, if the parties are in fact related, to make adjustments under domestic and treaty provisions dealing with associated enterprises, if prices paid to the processor are below arm's length amounts. These adjustments would result in increased profits taxed to the processing enterprise in the country of the PE. After such adjustments additional profits will also be taxed to the PE under both kinds of provisions set out above on the basis of similar reasoning to that used in relation to the agency PE.

6.82 Where third parties are involved in substantial equipment PEs,[110] the same reasoning applies. For example, if a non-resident has provided substantial equipment to an unrelated Australian agent to use to produce goods on its behalf,[111] the ATO does not accept that the deemed PE of the non-resident that arises will have no attributable profits. The argument for this conclusion would be on a similar basis

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[110] Assessment Act s 6(1) definition paragraph (b) "a place where the person has, is using or is installing substantial equipment or substantial machinery"; Vietnamese Agreement Article 5(4): "An enterprise shall be deemed to have a permanent establishment in a Contracting State and to carry on business through that permanent establishment if … substantial equipment is being used in that State by, for or under contract with the enterprise."

[111] Use of equipment includes this situation, see *Case H106* (1958) 8 T.B.R.D.(NS) 484.

as above, that the third party agent is fully remunerated in its fee for the work performed and the revenue attributable to the substantial equipment PE would be the same as the amount actually paid to the agent. The clear intent of such a substantial equipment provision is that the selling profit arising from the use of the equipment to produce goods for sale in Australia is taxable in Australia. For that purpose the selling price of the goods will be treated as attributable to the PE and an appropriate part of the expenses of the enterprise deducted including depreciation of the equipment if the enterprise is the owner of the equipment.[112] In the case of operation of equipment by the non-resident itself in Australia if the non-resident has staff operating, maintaining or otherwise associated with the equipment in Australia, the total revenue in relation to the operations of the equipment in Australia including that attributable to the work of the staff will be regarded as attributable to the PE.[113]

Your comments

10. If you wish to comment on this draft Ruling, please send your comments promptly by **26 January 2000** to

Comments by Date: 26 January 2000
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Commissioner of Taxation
15 November 2000

Previous draft:

Previously released in draft form as TR 1995/D11

Related Rulings/Determinations:

IT 2446; TR 92/11; TR 94/14; TR 97/20; TR 97/23; TR 98/11; TR 98/21; TR 1999/1; TR 1999/8

Subject references:

- accounting practice and taxation
- agents
- allocation of assets, liabilities and capital
- allocation of income and expenditure
- amended assessment
- arm's length principle
- associated enterprises
- 'attributable'

[112] See also paragraphs 4.90 to 4.94 above as to expenses of offshore repairs and downtime.

[113] Compare *Cudd Pressure Control Inc*, paragraph 6.20 above.

- attribution of profits
- banks
- *Basel* capital adequacy framework
- business profits
- business profits article
- capital allocation for banks
- capital allowances
- capital gains tax
- capital (interest free funding)
- companies
- correlative adjustment
- cost contribution arrangements
- 'cost toll' operation
- cost plus method
- cross border dealings
- 'CUP' method
- currency fluctuation loss
- debt
- deduction in earning Australian source income
- deduction in earning foreign source income
- deemed consideration
- deemed permanent establishments
- depreciation
- derivation
- determinations (Div 13)
- dividends
- documentation
- donations
- double tax agreements
- double taxation
- dual residents
- duration of a permanent establishment
- economic linkages
- economic ownership
- economically significant activities
- 'effectively connected'
- enterprise
- entertainment expenses
- equity
- exempt income
- exemption of foreign branch profits
- expenditure
- expenditure incurred in deriving income
- financial dealings
- financial institutions
- fixed place of business
- force of attraction principle
- foreign bank branches
- foreign beneficiaries
- foreign loss quarantining
- foreign partners
- foreign tax credits
- functional analysis
- funding
- global trading
- hedging
- income
- industrial and commercial profits
- installation project
- insurance with non-residents
- intangible assets
- interbranch loans
- interest
- interest on internal debts
- intermittent permanent establishments
- international agreements
- interbranch lending
- inter-segment charges
- intra-entity dealings
- jurisdiction to tax
- leasing
- 'Libor'
- losses
- management expenses
- mandatory or discretionary application
- mark-ups
- methodologies for attribution
- minimum capital requirements
- notional expenditure
- partnerships
- permanent establishments
- preparatory or auxiliary activities
- profits
- profit split method
- purchase of goods or merchandise for the enterprise
- repairs
- resale price method
- research and development expenditure
- residence
- risk-weighting
- royalties
- segmentation
- self assessment
- separate enterprise
- services
- single entity
- source
- source of income
- supervisory activities
- taxable income
- tax avoidance purpose
- taxpayers
- tax planning
- tax result
- thin capitalisation
- trading stock

- transfer pricing
- trust estates
- use of accepted transfer pricing methodologies
- use of assets
- use of substantial equipment

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- Article 5(3)(d)
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- Article 5(4)
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