THE TAX INSTITUTE

19 December 2012

Review of Tax Arrangements Applying to Permanent Establishments
The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600
Attn: Ms Annabelle Chaplain

By email: taxboard@treasury.gov.au

Dear Ms Chaplain,

Review of Tax Arrangements applying to Permanent Establishments

The Tax Institute is pleased to have the opportunity to make a submission to the Board of Taxation (**Board**) in relation to the *Review of Tax Arrangements applying to Permanent Establishments* Discussion Paper (**Discussion Paper**).

Summary

Our submission below addresses some of the issues raised in the Discussion Paper. In particular, we note that due consideration should be given to the impact (both intended and unintended (ie consequential)) of the functional separate entity treatment on both the branch and head office and equal attention should be paid to the tax implications for both inbound and outbound activities if this approach is adopted by Australia.

We have addressed in detail the issues raised in Chapters 2 to 5 of the Discussion Paper and in broader terms the issues raised in Chapters 6 and 7. We have not provided any response in respect of the issues raised in Chapter 8.

For our views on how rules affecting permanent establishments should interact with the transfer pricing rules, please refer to our submission to Treasury on the *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of Transfer Pricing Rules* Exposure Draft.

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Discussion

Currently in Australia, a "relevant business activity" approach is used to allocate income between the head office and the "branch" (permanent establishment) according to the functions performed by the different entities. An arm's length methodology is also applied for the purpose of working out the amount of profit that is taxable in the country where the branch is located. The OECD approach for recognising the permanent establishment as a "functionally separate entity" (**FSE**) encapsulated in the new Model Article 7 involves recognising internal transactions between the head office and branch for the purpose of determining the profit to be taxed in the country where the branch is located by treating the branch as a "separate entity" from the head office.

We have structured our response to follow the questions as numbered throughout Chapters 2 to 5. However, in respect of the issues raised in Chapters 6 and 7, we consider the issues raised on a broad basis.

1. Overall Policy Objectives and Principles for Assessment of the Functionally Separate Entity Approach

Q 2.1 – Issues/Questions

Reasons for using a permanent establishment

The reasons an organisation entering a new country to start up operations may use a permanent establishment rather than a subsidiary are many and varied and include the following:

- the commercial ease and flexibility a permanent establishment structure offers in the start-up phase of a business;

- as the size and permanence of an organisation's operation in a particular location is usually unknown, use of a permanent establishment structure provides the flexibility for the operation to start small and then grow and eventually be converted to another more formal legal structure (e.g. subsidiary) as and if required;

- depending on the industry in which an organisation operates, it may be preferable to establish a permanent establishment rather than a separate legal entity to operate in a particular location (e.g .the banking and insurance industries);

- a business that undertakes a specific project or utilises a mobile asset (e.g. drilling rig, surveying vessel, aircraft etc) in a specific location for a relatively short period of time may use a permanent establishment structure to take advantage of undertaking the project or using the asset globally without the

requirement to establish a local presence (i.e. subsidiary) each time and transfer/dispose of assets.

Types of Activities

The types of activities ordinarily undertaken by a permanent establishment will vary depending on the industry in which the organisation operates. Service providers to the resources industries, for example, can provide services such as engineering, procurement, installation and construction of a particular item (e.g. a pipeline, processing plant, LNG train, etc) at a particular location that are ordinarily handed over to the client on a “turnkey” basis. A majority of the work will occur overseas with the last phase of the work occurring in Australia, giving the item the relevant connection to Australia. It is not unusual for such service providers to operate in Australia through a permanent establishment.

An organisation may also be a global services provider that has a principal contractor in Australia. For commercial reasons, in these types of arrangements, the principal contractor sub-contracts with the various entities within the global organisation that provide different services (e.g. a UK-based engineering entity provides engineering services, the global employment entity provides labour, head office supplies management support services, etc). The Australian principal contractor could be a permanent establishment in this case. This is especially the case where the relevant contract is the first for the business in Australia. We observe generally that where this kind of contractor subsequently establishes a permanent presence in Australia (e.g. an office, operations, etc), that presence will usually be established through the incorporation of an Australian subsidiary.

Another example of typical activities that lead to the establishment of a permanent establishment is the “beachhead” type of operations often used in the funds management industry where the entity enters a particular jurisdiction initially on a temporary basis. This type of operation is undertaken especially where the organisation has a particular or unique expertise and wants to establish some kind of client-facing operation within a particular jurisdiction to facilitate service delivery and support to its clients and potential in that jurisdiction and does not yet want to establish a more permanent “structure”. Typically, this will involve the entity sending 2 to 3 employees to the jurisdiction and often this is enough of a “presence” to be regarded as a permanent establishment.

Further, typically a foreign fund manager may wish to have an employee operate in a particular time zone without establishing a representative office or other structure that would give rise to a permanent establishment (e.g. typically the employee may be employed by a US company and sent to live in Australia to operate in the “Asia Pacific” time zone and would work out of their home rather than an office). This structure is not ordinarily regarded as a permanent establishment.

As noted in the Discussion Paper, other kinds of businesses, such as banking and insurance entities, establish permanent establishments. This allows the organisation to

maintain the assets used to support the business of all its branches in any location and does not require the organisation to have to locate assets in the same locations as all its branches. It also allows those assets to be available to support transactions of and claims made against all branches, rather than the "support" given to the branch being limited by the assets only located in the same jurisdiction as the branch, (which is a limitation that does arise in the case of a separate legal entity such as a subsidiary).

Size/extent of use of permanent establishments vs subsidiaries

We note that this kind of information is recorded in the International Dealings Schedule (which replaces Schedule 25A) lodged by entities that have permanent establishments which we suggest ought to be able to be obtained from the Australian Taxation Office.

We note, however, that in the last decade, there has been a surge (in both number and scale) of foreign entities which have recently entered Australia to do business here that have historically not looked to operating in Australia, particularly in relation to the resources services industries.

2. The Authorised OECD Approach

Q 4.1 Issues/Questions

Other countries likely to adopt the new Article 7

Based on evidence noted in the Discussion Paper, certain key trading partners of Australia and the larger OECD member countries are looking to eventually adopt the new Article 7 into their bilateral treaties. Given the length of time it takes to negotiate new treaties with treaty partners and update them to adopt the new Article 7 (or a variant of it), Australia may end up in the "minority" if it does not look to consider adopting the new Article 7 into newly negotiated or renegotiated treaties.

Even though some of Australia's key trading partners, such as China and India, have expressly reserved their position on adopting the new Article 7[1], if they decide to not adopt the new Article 7, Australia does not necessarily want to be left behind simply by following suit of those particular trading partners. Rather, Australia should focus on who it mainly trades with and the nature of that trade (e.g. goods, services, source of capital investment) as this is relevant to also determining whether Australia should adopt the functionally separate entity approach for taxing permanent establishments.

Capital exporting countries appear to be favouring the adoption of the FSE approach, however, Australia is still a capital importer. Australia has significant trade relations with the United States and the United Kingdom, two major economies who, as the Board notes[2], are among several jurisdictions who are likely to adopt the new Article 7 into their newly negotiated treaties.

[1] Paragraph 4.33 of the Discussion Paper
[2] Paragraph 4.35 of the Discussion Paper

It may be the case that, rather than being able to adopt or reject the new Article 7 on a universal basis into all of Australia's treaties, whether new Article 7 is adopted or not will be determined according to the position held of the particular treaty partner with whom Australia is negotiating/renegotiating its treaty. This will give Australia an approach that is consistent with the particular treaty partner, that would be beneficial in both the negotiation process and afterwards once the treaty is settled. Taking this flexible approach will ensure that, unless it is determined that Australia should be opposed to adopting the new Article 7 (which is a view not held by The Tax Institute), Australia is not left behind and is free to include or not include new Article 7 in newly negotiated treaties.

Reasons other than the UN's reasons why countries may not adopt the new Article 7

It is The Tax Institute's view that proper and due consideration should be given to whether Australia should adopt new Article 7 rather than just seeking out reasons for not adopting it. There are arguments for adopting the FSE approach, such as:

- Australia has to date followed a hybrid type of approach to FSE treatment such that often, this type of treatment is already applied in relation to some aspects of taxing permanent establishments; and

- The interpretation contained in *Taxation Ruling TR 2001/11 Income Tax: International Transfer Pricing – Operation of Australia's permanent establishment attribution rules* of how profits are attributed to permanent establishments under Australia's double tax treaties is broadly consistent with the FSE approach (though this type of approach is not formally adopted in law as yet).

There are also reasons against adopting the FSE approach, such as:

- While appreciating the benefits of adopting the FSE approach, caution needs to be exercised to ensure it does not give rise to unintended consequences.

  For example (as discussed at paragraph 4.28 of the Discussion Paper), the potential for the creation of taxable gains or losses on the internal 'disposal' of assets between a head office and the permanent establishment upon a change in use or location. Such gains could arise under the depreciation provisions of the tax law as well as CGT K7.[3] In the case of CGT Event K7, this would build on what is already arguably an inappropriate outcome of the provision.[4]

[3] Refer section 104-520 of the *Income Tax Assessment Act 1997* (**ITAA 1997**).

[4] Being that the CGT Event applies equably to depreciable assets used for business purposes outside of Australia in the same manner as private use (as both do not give rise to the gaining or producing of Australian assessable income).

It is our view that the FSE approach should not give rise to such consequences where there has been no actual or underlying disposal.

- In our view, the FSE approach should not also give rise to withholding taxes (e.g. royalty and interest withholding tax) on internal transactions, e.g. lease charges or interest.

  Australian tax law already allows for the imposition of such withholding tax where the royalty or interest payable is paid by the foreign company but attributable to its Australian permanent establishment.[5] That is, Australia already has taxing rights over the actual amounts of interest and royalties paid or incurred by the taxpayer that are attributable to Australia.

- The FSE approach could also result in an inappropriate mark-up for services provided between the head office and the PE or give rise to a charge for services or functions being imposed on the PE because it is regarded as "functionally separate". If the PE is small relative to the rest of the group (e.g. there are 100 people in Australia out of a total of 20,000 people employed by a multinational corporation) and is treated as functionally separate, how should the PE work out the "charge" for services from the head office? Is the charge for services to be quantified by the amount of services actually consumed or required to be consumed or is it based on amount of services the PE would have been taken to have consumed if it is regarded as functionally separate?

- How certain structures (like the "beachhead" structure or the single employee working in a particular jurisdiction out of their home) may be treated under the FSE approach and whether adoption of the FSE approach may result in "worse" rather than "better" treatment for these types of entities. For example, how will these types of entities be regarded under the FSE approach? Is it appropriate to apply the FSE approach? Could adoption of the FSE approach impose transfer pricing obligations on these types of entities that are not currently imposed on these entities and therefore an additional cost burden in some circumstances where it doesn't need to? The ATO has always taken a "practical approach" with regard to these types of structures[6], but the question then arises whether this practical approach will be retained or indeed whether the ATO will even be able to retain it if the FSE approach is adopted..

Other innovations in Australia's international taxation policy, such as the amendments to the transfer pricing rules currently underway, are moving towards aligning with international best practice following OECD guidelines.

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[5] For example, see section 128B(2)(b)(ii) of the *Income Tax Assessment Act* 1936 (**ITAA 1936**) for interest.

[6] See, for example, "International transfer pricing - a simplified approach to documentation and risk assessment for small to medium businesses" at http://www.ato.gov.au/taxprofessionals/content.aspx?menuid=0&doc=/content/48756.htm&page=1&H1

In our view, the benefits for adopting the OECD approach far outweigh the reasons for not adopting this approach. Further, adopting (as much as possible) the FSE approach is consistent with other changes occurring in Australia's international taxation policy.

3. Adopting the Authorised OECD Approach in Australia

Q 5.1 Issues/Questions

The Tax Institute regards the OECD's approach in the form of FSE treatment for permanent establishments as fundamentally superior to the current treatment of permanent establishments applied in Australia. Adoption of this approach is likely to provide better outcomes than the current position provides. We refer to the specific issues raised by the Board separately below.

Implications for domestic tax law and tax treaty policy of Australia adopting the OECD approach

The FSE approach applies best to permanent establishments with active businesses, but for a variety of reasons (including those discussed above) it is not necessarily an appropriate treatment for deemed permanent establishments (such as one which arises through a lease of (in the case of Australia's tax treaties, substantial) equipment) because of the focus on the "functions" of the permanent establishment and risks assumed (a deemed permanent establishment does not necessarily have any "functions" or assume any risks). Where such functions or risks exist in Australia, our view is that both the current and proposed transfer provisions already ensure appropriate Australian tax recognition of those activities.

In our view, Australia needs to ensure that, with any new approach to the treatment of permanent establishments, it factors in protection of, and the ability to access, Australia's natural resource reserves as well as the ability to access scarce capital resources and services (e.g. drilling rigs, specialist vessels, engineering and consulting services etc) commonly operated by multinational business through permanent establishments.

Consideration also needs to be given to the possible impact of the FSE approach on an entity established under a trust since the trust structure is used so prolifically in Australia.

In this regard, carve outs will be needed from the OECD approach to permanent establishments if adopted into Australian domestic law. However, the focus of the current exercise by the Board should be squarely on getting the approach right that best suits the majority of permanent establishments subject to Australian domestic tax law (factoring in the nature of activities typically undertaken by permanent establishments inbound and outbound) while bearing in mind the need for these exceptions, rather than having the need for these exceptions (or special cases) dominating the process of determining whether this approach should be adopted.

Adoption of approach on a treaty by treaty basis or uniformly in Australian domestic law

Based on our comments contained at Part 2 above, The Tax Institute supports the adoption of the OECD approach on a treaty by treaty basis. We note that it will take a substantial amount of time for Australia to renegotiate its entire treaty network (comprised of 45 treaties), however renegotiation of Article 7 need only be undertaken at the time each treaty is renegotiated and the new Article 7 could be brought into negotiations with new treaty partners with whom Australia does not have a pre-existing treaty.

This may result in differing treatment of permanent establishments depending on which treaty the taxation of the permanent establishment is subject to, however it will allow for consistency of treatment with specific treaty partners. As there are already differences between the same Articles employed across Australia's treaty network[7] adopting this approach should not result in a situation much different to one to which we are accustomed. Though these differences may be minor, the differences between the two types or Article 7's will be well-understood and accounted for.

Principles to follow in amending domestic income tax law if the OECD approach was to be adopted into Australian domestic law

In making amendments to the Australian domestic law should the decision be made to adopt the FSE approach, due regard should be given to the following:

- Ensure the adoption of the FSE approach does not give rise to taxable gains or losses where no actual transactions or disposals have taken place;

- Ensure the imposition of withholding taxes on 'internal' transactions (between head office and PE) does not impose an unintended economic cost on the business by, for example, such a transaction being disregarded in the home country of the taxpayer, such that no credit or offset is available in that jurisdiction for any Australian withholding tax; and

- Consider whether it may be necessary to amend the transfer pricing laws (Division 13 of the ITAA 1936 or Division 815 of the ITAA 1997) to accommodate this change should it occur.

Special rules for capital allocation to branch operations if OECD approach is adopted?

There is some guidance in OECD Report[8] regarding allocating capital to the PE under the FSE approach. To ensure consistency is obtained between countries that adopt the

[7] For example, see the significant variation in Australia's tax treaties around the requirements for a deemed permanent establishment arising in respect of substantial equipment.
[8] *2010 Report on the Attribution of Profits to Permanent Establishments* OECD (22 July 2010)

FSE approach for the purpose of taxing branches, The Tax Institute recommends following the OECD guidelines.

If the OECD guidelines for capital allocation are going to be followed, The Tax Institute queries whether a similar approach should also be taken in respect of allocating capital to subsidiaries. Should the approach that applies to allocating capital to subsidiaries be changed to follow the approach that may be adopted for PEs if Australia adopts the FSE approach? If so, this may require examination of the CFC and FAF rules (once introduced or perhaps during their design phase) to ensure that there is a consistent approach to allocating capital for both subsidiaries and branches/PEs. The Tax Institute suggests that Australia should adopt a similar approach for the allocation of capital for PEs and subsidiaries.

Impact on current tax practices of adopting the authorised OECD approach

Should Australia adopt the FSE approach, Australian entities will need to examine their existing transfer pricing methodologies currently in place and consider whether their current policies are appropriate and consistent or inconsistent with the FSE approach.

This may or may not require these entities to make changes. However, there are potential flow-on consequences if the FSE approach is adopted in some treaties and not others where entities may have to have several transfer pricing methodologies in place to align with FSE treatment for some PEs and different treatment for other PEs. This could potentially create undue administrative burdens on entities with PEs in many jurisdictions that have varying approaches as to how PEs are to be regarded.

Also, the creation of taxable gains or losses on the 'disposal' of scarce tangible mobile assets upon a change in use or location as a consequence of adopting the FSE approach will provide a major disincentive to multinational business allocating those assets to Australia as compared to other jurisdictions.

Q 5.2 Issues/Questions

Impact on inbound and outbound activities of multinational corporations

Attention needs to be paid to the treatment of both inbound and outbound transactions where under the FSE approach ideally treatment of both types of transactions should be symmetrical or, if symmetry cannot be attained, then treatment that is close to giving symmetrical treatment should be applied. There could be a whole variety of flow-on consequences where proper attention is not given to the tax implications for both inbound and outbound transactions.

Particular issues for deemed permanent establishments and special purpose/project permanent establishments

For the reasons discussed above, it is difficult to regard a deemed permanent establishment as functionally separate from the main entity. It is therefore (at a

minimum) difficult to determine this type of permanent establishment's tax liabilities under the FSE approach. As noted above, a carve-out may be required to deal with this special type of permanent establishment.

These types of permanent establishments arise most commonly in the resources services industry where globally mobile assets of significant value are leased into or operated in Australia.

Issues arising include to whom the tangible asset should be attributed and to whom the risks associated with the operation of the equipment being operated should be attributed.

Substantial equipment is often leased by its owner on a fixed price or "no risk" (at least to the lessor) basis (i.e. by way of a bareboat lease or dry charter (depending on the industry)) and the lessor derives a fixed and risk-free income stream.

The risk associated with the utilisation/performance of the equipment under such passive lease arrangements is then passed on to the lessee.

In this regard, it is important to note that a deemed permanent establishment of this nature does not generally arise in other jurisdictions, nor are equipment lease payments generally regarded as payments of royalties as they are in Australia.

Therefore, under a FSE approach, royalty withholding tax could apply to equipment lease payments "paid" by an Australian permanent establishment to its head office**.** In addition, if the permanent establishment has "borrowed" funds from its head office to acquire the equipment, the question arises whether the interest might also be subject to withholding tax in Australia if FSE treatment is applied to the branch.

If appropriate changes are not made to the Australian tax law, withholding tax may be imposed on interest or royalty payments made by the head office to third parties which are attributable to the Australian permanent establishment (as discussed above).

4. Adopting the Authorised OECD Approach – Specific Kinds of Entities and Administration, Compliance and Revenue Impacts

The points made above can be applied to the specific kinds of entities and particular issues raised in Chapters 6 and 7 of the Discussion Paper. In broad terms, these points are:

- There is potential for "tension" to apply between the treatment of certain activities or certain entities for tax purposes in one (a "foreign") jurisdiction differs to the treatment in another (the "home") jurisdiction and whether competitive neutrality between the two jurisdictions can arise.

- A “principles-based” approach should be taken to amending the Australian domestic tax law if the FSE approach is chosen to be adopted domestically both in respect of the general laws to apply and any specific laws to apply to specific kinds of entities.

- The Discussion Paper focuses on the “branch” (the PE), but due regard needs to also be given to the impact on the head office if the FSE is to be adopted both as it applies to specific kinds of entities in specific industries that may require a specific set of rules (such as banking and finance and insurance) and as it applies more broadly to entities in other industries that are subject to the general rules.

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0011.

Yours sincerely

Ken Schurgott
President