TA 2016/7 - Arrangements involving offshore permanent establishments

 This cover sheet is provided for information only. It does not form part of *TA 2016/7 - Arrangements involving offshore permanent establishments*

 It is noted that Australia's hybrid mismatches rules contained in Division 832 (together with hybrid mismatch rules implemented in other countries) are likely to have impacted arrangements detailed in this Taxpayer Alert. In many cases, taxpayers have unwound such arrangements as a result. This Taxpayer Alert is archived in light of the declining presence of these arrangements however we still consider the contents to be an accurate reflection of our non-compliance concerns with respect to these arrangements, notwithstanding the operation of hybrid mismatch rules in Australia or overseas.

Australian Government
Australian Taxation Office

Taxpayer Alert

TA 2016/7

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This Alert provides a summary of our concerns about a significant, emerging or recurring higher risk tax issue that we currently have under risk assessment.

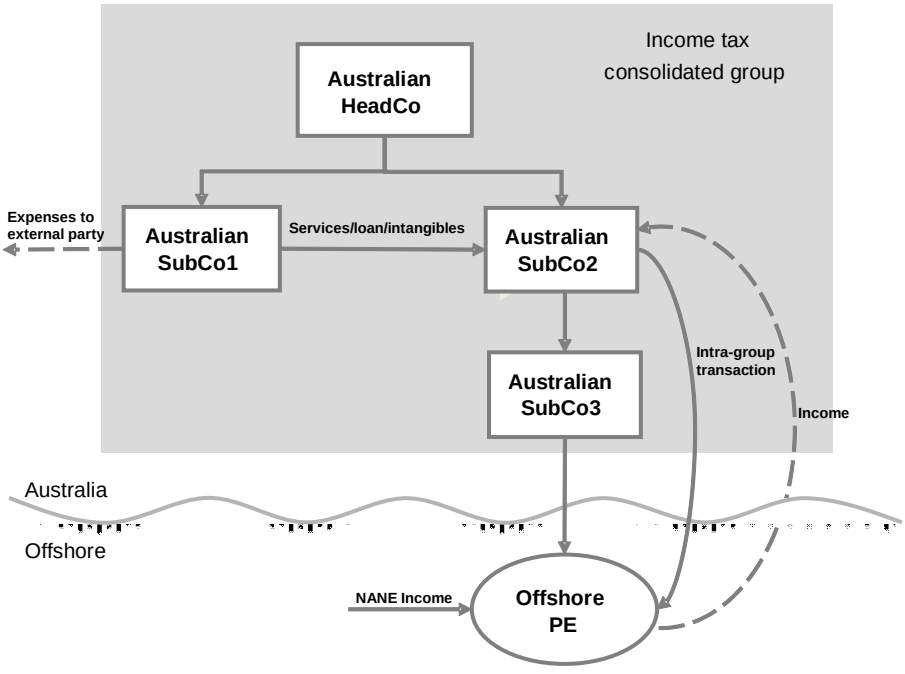
While an alert describes a type of arrangement, it is not possible to cover every potential variation of the arrangement. The absence of an alert on an arrangement or a variation of an arrangement does not mean that we accept or endorse the arrangement or variation, or the underlying tax consequences.

Refer to PS LA 2008/15 for more about alerts. See Alerts issued to date.

Description

We are currently reviewing arrangements involving Australian income tax consolidated groups (the consolidated group) with subsidiaries using offshore permanent establishments (PE) that have entered into intra-group transactions.

The diagram below illustrates an example of the type of arrangement being reviewed.



Such arrangements involve the taxpayer effectively asserting for Australian income tax purposes there is no substantive contribution from Australia to the business carried on, at or through the Offshore PE. However, they also involve the Offshore PE asserting the amount of the deduction it is entitled to in the foreign jurisdiction for the goods or services provided to its business by Australia (such as the services provided by Australian SubCo2 in the example above) is substantive, and consistent with transfer pricing principles.

We are concerned that, under these arrangements, the right amount of taxable income is not being returned by the consolidated group in Australia. In particular, that the amount of taxable income returned does not reflect the economic substance and significance of the operations carried on in and between Australia and the offshore jurisdiction consistent with the arm's length principle in our transfer pricing rules.

These arrangements typically display all or most of the following features, as illustrated in the diagram above:

- An Australian resident entity (Australian SubCo3), a member of a consolidated group, establishes a fixed place of business offshore through which it carries on business (the Offshore PE).
- Australian SubCo3 derives income from third parties or related entities who are not members of the consolidated group.
- The consolidated group asserts most, if not all, of the income derived by Australian SubCo3 is derived from foreign sources in carrying on business at or through the Offshore PE with the consequence that the income is treated as non-assessable non-exempt for Australian income tax purposes under section 23AH of the *Income Tax Assessment Act 1936* (ITAA 1936).
- In carrying on its business, Australian SubCo3 contracts to acquire goods or services from another member of the consolidated group, Australian SubCo2. The dealings could involve a loan of money, licence of intellectual property or other forms of goods or services. Australian SubCo3 is obliged to pay Australian SubCo2 for the goods or services, for example, interest, royalties or some other form of consideration.
- The contract entered into between Australian SubCo2 and Australian SubCo3 is an intra-group transaction. The head company of the consolidated group (Australian HeadCo) does not recognise the amount received by Australian SubCo2 as assessable income in the Australian consolidated income tax return (on the basis the transaction is ignored under the consolidation single entity rule (section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997)), but the payment is taken into account as an expense of Australian SubCo3 in working out Australian SubCo3's liability to tax in the foreign jurisdiction.
- Other entities in the consolidated group (e.g. Australian SubCo1) perform activities, incur liabilities or hold assets (e.g. services, loans or high value intangibles) that directly or indirectly contribute to the derivation of the income by Australian SubCo3. Those entities may or may not claim allowable deductions in respect of these activities, liabilities or assets. For example –
    - Australian SubCo1 may source funds from an unrelated external lender that are then indirectly on-lent to finance the operations of the Offshore PE. Australian HeadCo claims a deduction for the interest payments on the external borrowing in the Australian consolidated income tax return.

- Staff in Australian SubCo2 may undertake work for the Offshore PE. Deductions are claimed for the employee expenses in the Australian consolidated income tax return.
- Australian SubCo1 may incur expenditure in developing intellectual property that is licensed to the Offshore PE.

What are our concerns?

We have concerns that, in adopting this arrangement, consolidated groups may be understating their assessable income and/or incorrectly claiming deductions for expenses incurred in deriving non-assessable non-exempt income for Australian income tax purposes.

Specifically, we are concerned consolidated groups are:

- Failing to return sufficient assessable income in Australian consolidated income tax returns, either by treating excessive amounts of income connected to Offshore PEs as non-assessable non-exempt income under section 23AH of the ITAA 1936 and/or by ignoring intra-group receipts, in circumstances where other members of the consolidated group or offshore related entities have made a significant contribution towards the business carried on, at or through the Offshore PE.
  - This may be through a misunderstanding of the requirements of section 23AH and the consolidation provisions in Part 3-90 of the ITAA 1997 understood in the context of a statutory scheme that includes the arm's length rules in section 136AE(4) of the ITAA 1936 and Subdivision 815-C of the ITAA 1997.
  - It may involve a misunderstanding of what it means for income to be derived by a company in carrying on a business at or through a PE. While identifying that a PE exists and undertakes certain activities on behalf of Australian SubCo3 is an essential step in the analysis, it does not, of itself, mean all of the income Australian SubCo3 derives has been derived at or through the Offshore PE.
  - It may also involve a misapplication of the deemed source rules included in some of Australia's double tax agreements for the purpose of ensuring Australia, as the country of residence, does not double tax business profits that have been taxed in another jurisdiction in accordance with those agreements.
- Incorrectly claiming deductions for expenses related to the gaining or producing of non-assessable non-exempt income.

If the tax effect of these arrangements is as suggested, the result would be the double non-taxation of income; that is, income would be sheltered from tax in the foreign jurisdiction (by reason of the foreign jurisdiction allowing a deduction for the intra-group expense) which is not brought to tax in Australia (by reason of the intra-group receipt being ignored under the single entity rule in section 701-1 of the ITAA 1997). This would be an anomalous outcome and inconsistent with the purposes underlying the consolidation provisions and Australia's double tax agreements. In some cases, where deductions are claimed in Australia for external expenses relating to the Offshore PE's activities, the purported tax effect is not just double non-taxation of this income, but, in fact, tax relief against other domestic activities.

Arrangements which result in the double non-taxation of income or anomalous outcomes may also contain features which would attract the application of the general anti-avoidance rules in Part IVA of the ITAA 1936.

What are we doing?

We are currently reviewing these arrangements and are actively pursuing compliance activities in relation to a number of cases, in particular, focussing on those where inconsistent approaches are being taken in relation to the application of the arm's length principle and/or deductions claimed in Australia. Compliance activity will continue and we are developing our technical position in response to the facts and circumstances of each particular arrangement.

We will canvass our concerns in more detail in due course.

What should you do?

If you have entered into, or are contemplating entering into, an arrangement of this type we recommend that you seek independent advice, review your arrangement or discuss your situation with us by emailing PGIAdvice@ato.gov.au

References

Legislative References:

Income Tax Assessment Act 1936
- 23AH
- 136AE(4)
- Pt IVA

Income Tax Assessment Act 1997
- Pt 3-90
- 701-1
- Subdivision 815-C

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Authorised by:	**Jeremy Hirschhorn** Deputy Commissioner
Contact officer: Business line: Phone:	**Deborah Vegar** Public Groups and International (02) 9374 2872