TR 2001/11 - Income tax: international transfer pricing - operation of Australia's permanent establishment attribution rules

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This ruling contains references to repealed provisions, some of which may have been rewritten. The ruling still has effect. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten. The legislative references at the end of the ruling indicate the repealed provisions and, where applicable, the rewritten provisions.

This ruling contains references to repealed provisions, some of which may have been re-enacted or remade. The ruling has effect in relation to the re-enacted or remade provisions. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten.
Australia's tax treaties and other agreements except for the Taipei Agreement are set out in the Australian Treaty Series. The citation for each is in a note to the applicable defined term in sections 3AAA or 3AAB of the International Tax Agreements Act 1953.

This document has changed over time. This is a consolidated version of the ruling which was published on *29 November 2006*

Taxation Ruling
Income tax: international transfer pricing – operation of Australia's permanent establishment attribution rules

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Preamble

The number, subject heading (the title), ***Class of person/arrangement, Date of effect*** *and* ***Ruling and explanation*** *parts of this document are a 'public ruling' for the purposes of Part IVAAA of the* ***Taxation Administration Act 1953*** *and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

Class of person/arrangement

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 those in applying

[1] 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.

Australia's transfer pricing rules to international dealings between separate legal entities, as per Taxation 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. 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) this Ruling follows relevant guidance provided by the OECD[3] except:

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

(ii) where there is no consensus within the OECD on a particular matter or issue relevant to attributing profits to a PE;

(c) the same principles apply to all dealings where the taxpayer has a PE, either in Australia or overseas.

5. This Ruling does not discuss in detail whether a PE is in existence[4]. A fixed place of business of an enterprise through which its business is wholly or partly carried on will generally be a PE. Each place of business in a country will constitute a separate PE.

6. This Ruling does not address PE attribution issues that are of special importance to, or are particular to, financial institutions, including capital allocation for multinational banks, interbranch lending and global trading. The ATO intends to issue a separate Ruling dealing with these issues.

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[3] See 1994 Report entitled *Attribution of Income to Permanent Establishments*; Issues in International Taxation No.5, OECD, Paris, 1994; Commentary on Article 7 in the OECD Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital*, Paris (loose leaf). Consideration has also been given to the February 2001 OECD Committee on Fiscal Affairs, Discussion Draft on Attribution of Profit to Permanent Establishments (February 2001).

[4] See Taxation Ruling TR 2001/D6.

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.[5]

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 Review of Business Taxation (J.T. Ralph Chairman), Report. *A Tax System Redesigned*, July 1999 (Ralph Report)[6], further developments (possibly including legislation) may be expected.

Detailed contents list

9. Below is a detailed contents list for this Ruling:

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[5] Refer paragraphs 21 and 22 of Taxation Ruling TR 92/20.
[6] Commonly known as the Ralph report.

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Ruling and explanation

Chapter 1 The role and structure of Australia's PE attribution rules

Attribution rules under ITAA[7]

1.1 The general principles for calculating the taxable income of a taxpayer under the ITAA do not have regard to whether the taxpayer has 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).[8] Most deduction provisions require some relationship to assessable income, for example, general deductions under section 8-1, and capital allowance deductions under Division 40 of the ITAA 1997.

1.2 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.[9] 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.

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[7] The *Income Tax Assessment Act 1997* (ITAA 1997) and the *Income Tax Assessment Act 1936* (ITAA 1936).

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

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

1.3 There is little detailed guidance in the ITAA on the allocation of deductions between income sourced in Australia and elsewhere and the matter is largely determined under common law rules.[10]

1.4 Subsections 136AE(4), (5) and (6) introduce the PE concept in the sourcing of income and allocation of expenditure. The three subsections are parallel provisions dealing with the calculation of taxable income where a taxpayer has a PE. The basic principle is contained in subsection (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, the views in this Ruling are expressed in terms of subsection (4), but will, in general, apply also to subsections (5) and (6). Subsection 136AE(4) applies to both individuals and companies, however as most cases in practice involve companies, the Ruling is expressed in terms of company taxpayers.

1.5 Subsection 136AE(7) sets out the criteria to be considered in applying subsection 136AE(4), with the second of these, the arm's length principle, being the most important[11].

1.6 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 entities. This aspect of subsection 136AE(7) is discussed in Taxation Ruling TR 94/14.[12] 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.

1.7 Subsection 136AE(4) deals with the sourcing of income and allocation of deductions of a taxpayer as between Australia and elsewhere if the taxpayer is an Australian resident with an overseas PE or a non-resident with a PE in Australia. Such sourcing and allocation are to have regard to the arm's length separate enterprise principle under paragraph 136AE(7)(b), so that the tax outcomes for a PE are generally consistent with treating it as separate from the rest of the enterprise and dealing with it on arm's length terms.

1.8 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 arm's length separate enterprise principle. It does not create income or expenditure but takes them as given from the rest of the

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[10] See *Ronpibon Tin NL v. FC of T* (1949) 78 CLR 47; Ruling IT 2446.

[11] See Explanatory Memorandum to Income Tax Assessment Amendment Bill 1982, p.73

[12] Refer paragraphs 418 - 419.

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

1.9 The express 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.

1.10 The only case in Australia which squarely raises this issue is *Max Factor and Co. v. FC of T*[13], which supports the view that 'transactions' between head office and PE are disregarded in determining income derived or expenditure incurred. 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.

1.11 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 DTAs

1.12 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 can be contrasted with 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).

1.13 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 from business profits 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

[13] 84 ATC 4060; 15 ATR 231.

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 primary adjustments to increase Australian tax.

1.14 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

1.15 Despite the differences in purpose and drafting, the rules in the DTAs 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.

1.16 The OECD Committee on Fiscal Affairs, Commentary on Model Tax Convention on Income and Capital, OECD, Paris (loose leaf) (OECD 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. Double taxation resulting from these differences may be resolved using the mutual agreement procedure.

1.17 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.[14]

Alternative approach adopted by some countries

1.18 The words of Article 7(2) of the OECD Committee on Fiscal Affairs, Model Tax Convention on Income and Capital, OECD, Paris (OECD Model Convention) and Australia's DTAs have been regarded in cases overseas as clear and directive: a separate enterprise is to be

[14] 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.

hypothesised, transactions 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.

1.19 For example, in the recent United States decision of *National Westminster Bank plc v. USA*[15], a UK bank with a branch in the US included interbranch loans in its accounts for tax purposes. Regulation 1.882-5 under the United States Internal Revenue Code contained provisions for calculating 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. First, the regulation disregarded all interbranch transactions. Secondly, the regulation provided for interest deductions to be determined by a formula rather than on the basis of the separate independent operations of the branch. There are also decisions overseas contrary to the *Max Factor* case.[16]

1.20 The ATO does not accept that the business profits article in Australia's tax treaties operates on a strict separate entity basis. Further, there are foreign decisions to the same effect. In *Cudd Pressure Control Inc v. The Queen*[17] 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,[18] 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.

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15 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 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.

16 See cases referred to in Vogel, K., *Klaus Vogel on double taxation conventions: a commentary to the OECD-, UN-, and US model conventions for the avoidance of double taxation on income and capital, with particular reference to German treaty practice;* 3rd edition; Kluwer Law International, London 1997, at page 430.

17 95 DTC 559; [1995] 2 CTC 2382.

18 98 DTC 6630.

1.21 The Ralph Report recommended a progressive introduction in appropriate circumstances of separate entity treatment in Australia.[19] The Ralph Report also notes that some caution needs to be exercised in this direction where there is no consensus within the OECD.

Chapter 2 The interaction between tax rules that affect PEs

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

2.1 The business profits article, in common with other treaty provisions, incorporates relevant Australian domestic tax law by operation of the Agreements Act. Thus, it sits alongside the provisions of section 136AE under the legislative framework.[20]

2.2 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.[21]

2.3 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.

2.4 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[22]. In other DTAs, the circumstances include exceptional difficulties[23].

2.5 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 does not mean that the DTA provisions referred to are ineffective. Subsection 136AE(4) does not require (like subsections 136AD(1) to (3)) that the arm's length consideration be substituted. Rather, the arm's length separate enterprise principle is a matter that goes to the

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[19] Recommendation 22.11 at pages 668 to 670.
[20] Refer subsection 4(1) Agreements Act.
[21] Refer subsection 4(2) Agreements Act.
[22] See e.g., paragraph 5 of Article 7 of the Vietnamese agreement.
[23] See e.g., paragraph 5 of Article 7 of the Korean agreement.

exercise of a general discretion and the Commissioner is permitted to consider other matters which are regarded as relevant (paragraph 136AE(7)(c)).

2.6 The matters referred to in the DTAs (i.e., inadequate information or exceptional difficulties) 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 arm's length separate enterprise principle. Approaches or methodologies authorised under subsection 136AD(4) in separate enterprise cases[24] are authorised under subsection 136AE(7) in PE cases.

2.7 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.

2.8 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. 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)(e) requires a connection to the PE[25].

2.9 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 arm's length separate enterprise 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.

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

2.10 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

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[24] See Taxation Ruling TR 97/20 paragraphs 1.15 to 1.24.

[25] See, for example, Article 7(1) of the Indonesian agreement which permits taxation of profits for goods and services of a similar kind to those provided through the PE.

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 subsection 136AE(1) 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 consideration for a dealing between an entity 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. To the extent that subsection 136AE(1) applies to deem an Australian source for the relevant income, paragraph 136AE(4)(c) prevents subsection 136AE(4) from applying to that income. 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.[26]

2.11 Some slight uncertainty exists as to whether 'any income' in subsection 136AE(4) includes an amount of deemed consideration under section 136AD. Accordingly, a prudent approach is to apply subsection 136AE(1) with respect to a section 136AD amount in preference to subsection 136AE(4). In any event there should be no difference in the outcome under subsection 136AE(1) or subsection 136AE(4) in a PE case, given that the same criteria in subsection 136AE(7) apply, in particular the arm's length separate enterprise principle under paragraph 136AE(7)(b).

2.12 The application of section 136AD and subsection 136AE(4) potentially overlaps as a result of the words "and other persons" in paragraph 136AE(7)(b). This permits regard to an arm's length outcome for dealings of a taxpayer through its PE with other entities. However, this is only for the purposes of the process authorised under subsection 136AE(4), i.e., allocating the taxpayer's actual income and expenditure, and it is not free from doubt that the words referred to enable adjustment to such income and expenditure. The application of section 136AD and subsection 136AE(1) in such cases avoids this problem[27].

Relationship of business profits and associated enterprises articles of DTAs

2.13 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

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

[27] See Example at paragraphs 2.15 to 2.19 below.

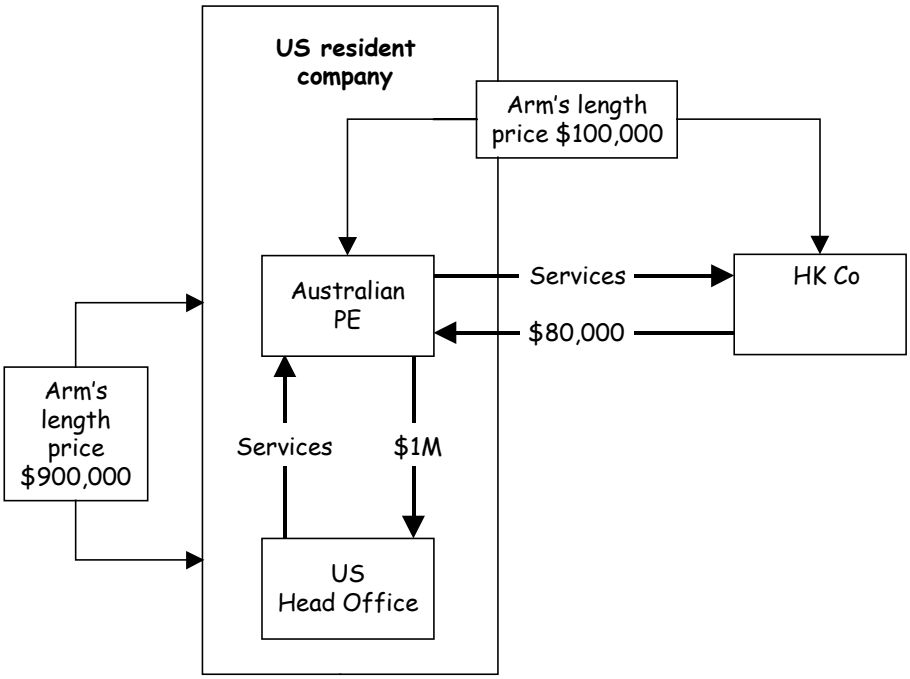
enterprises article is expressed in permissive form, it is considered that the business profits article takes precedence in the sense that it operates automatically. It does not, however, prevent an operation of a further adjustment under the associated enterprises article to the extent that the adjustment under the business profits article falls short of satisfying the arm's length principle with respect to an associated enterprise.

2.14 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 raises an issue of potential overlap of the article with the associated enterprises article and section 136AD, similar to that discussed at paragraph 2.12 above in respect of section 136AD and subsection 136AE(4). Similarly, the application of section 136AD or the associated enterprises article of a relevant DTA in conjunction with the business profits article will avoid any problem in bringing an adjusted consideration for a dealing of a taxpayer's PE with another enterprise into account in attributing actual profits of the taxpayer to that PE. In these situations, and also where the applicable business profits article does not include the words referred to[28], section 136AD or an applicable associated enterprises article may be used to adjust for any non-arm's length dealings between the taxpayer and another entity, ensuring that the taxpayer's business profits are correct before attribution of profits to the taxpayer's PE under the business profits article.

Example

2.15 The interaction of the rules in Division 13 and the DTAs relevant to PEs may be illustrated using the following example. ABC Corporation (ABC) is a United States resident MNE whose business is the provision of consultancy services. To provide these services in Australia, ABC leases an office in Sydney staffed with expatriate and locally recruited employees (i.e., a PE). ABC's head office provides management and administrative support services to its Australian operations. An annual charge of $1M is recorded in ABC's accounts for this. Staff of the PE provide consultancy services to ABC's Hong Kong subsidiary (HK Co). A charge of $80,000 is recorded in the accounts for this. Assume that an arm's length charge for the service between head office and PE is $900,000, and for the service between the PE and HK Co is $100,000. This situation is illustrated below.

[28] See agreements with United Kingdom, Japan, Germany, France and Korea.



2.16 The possible application by the ATO of the relevant provisions in Division 13 and the United States DTA in this case is discussed below.

Charge between head office and PE

2.17 Article 7 of the DTA could be applied to increase the profits of the PE by $100,000. The amended assessment issued to effect this adjustment might prudently be supported by a determination under subsection 136AE(4) that $900,000 represents the extent to which ABC's income and/or expenses in respect of the services relate to sources in Australia.

Charge between PE and HK Co

2.18 Section 136AD could be applied to deem ABC to have derived $100,000 for the services to HK Co. In this regard, the acquisition of the services by HK Co would give rise to an "international agreement" under paragraph 136AC(a) for subsection 136AD(1) purposes. Then, either subsection 136AE(1) or subsection 136AE(4) could be applied to deem an appropriate portion of the $100,000 (presumably the full amount in this case) as related to sources in Australia. Alternatively, DTA Article 7 could be applied to attribute the $100,000 to ABC's Australian PE.

2.19 As another alternative, DTA Article 7 could be applied without a section 136AD determination to achieve the same outcome. This

alternative application of Article 7 would rely on the words "or with other enterprises with which it deals" in paragraph 7(2) to directly give effect to an arm's length outcome for the PE's dealing with HK Co. A similar application of subsection 136AE(4) could be used relying on the words "and other persons" in paragraph 136AE(7)(b). As previously discussed, the legal effectiveness of such an application of Article 7 or subsection 136AE(4) is not entirely free from doubt, and thus it would prudently be used only as an alternative to support an amended assessment in this case.

Relationship of subsection 136AE(4) and sections 38 to 43

2.20 Sections 38 to 43 provide rules for determining taxable income in some circumstances which can overlap with subsection 136AE(4). Unlike subsection 136AE(4), sections 38 to 43 are self-operating and do not depend upon 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.

2.21 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.

Chapter 3 Concepts and interpretation of PE attribution rules

Tax result

ITAA

3.1 Paragraph 136AE(4)(d) means that the subsection can only apply if a determination under it produces a greater tax result than that based upon the tax return lodged.

3.2 The 'tax result' is to be assessed broadly. 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.

3.3 If a taxpayer wishes to challenge an ATO determination under subsection 136AE(4), recourse to the normal domestic appeal procedures will be necessary. If the taxpayer wishes to change its own allocation of income and expenditure in its original return, it cannot require the ATO to make a determination under subsection 136AE(4). It will be necessary to self amend or challenge the original assessment (or deemed assessment) under normal domestic rules as appropriate.

3.4 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

3.5 The business profits articles of DTAs contain no precondition for their operation depending on the tax result. A taxpayer can self-assess by applying the business profits article of a DTA whether the result is to increase or reduce tax payable. 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 agreement procedures[29].

Mandatory or discretionary application

ITAA

3.6 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

[29] See Taxation Ruling TR 2000/16.

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.[30]

DTAs

3.7 The business profits articles of DTAs are 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.[31]

Types of taxpayers

ITAA

3.8 Allocation questions may arise in relation to business activities carried on by 'taxpayers', either in the ordinary subsection 6(1) meaning of that term (a person deriving income, with '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.

3.9 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

3.10 The business profits article applies to an 'enterprise'. In this context the term 'enterprise' may mean either 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, which concerns an enterprise

[30] See Taxation Ruling TR 97/20 paragraph 1.1.
[31] See above under 'tax result'.

participating in the management, control or capital of another enterprise. The other meaning, which applies in the context of the business profits article, is that of the activity carried out, including continuing conduct or isolated transactions entered into for business or commercial purposes.[32]

3.11 The links between the 'enterprise' under the business profits article and the 'taxpayer' under domestic law are provided by the treaty definitions of 'enterprise of a Contracting State' and 'enterprise of the other Contracting State', 'person' and 'resident'.[33] Where the business profits article refers to an enterprise carrying on business or activities, 'enterprise' refers to the taxpayer according to Australian law carrying on the relevant activities.

3.12 The application of DTAs to partnerships is a much debated issue on which the OECD has recently released a Report.[34] 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.

3.13 In the case of trustees, Australia has introduced provisions into the Agreements Act and treaties[35] 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.

3.14 Subsection 3(11) of the 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 arguably do not have their own PEs. As a result of these provisions, the outcome is in practice the same as under subsection 136AE(6).

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[32] *Thiel v. FC of T* 90 ATC 4717; 21 ATR 531.

[33] See Articles 3 and 4 of the Vietnamese agreement.

[34] OECD Committee on Fiscal Affairs, *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation No.6, OECD, Paris, 1999.

[35] For example, Article 7(8) of the Vietnamese agreement.

Attribution

3.15 Paragraph 136AE(4)(e) limits the subsection to applying only if, in the Commissioner's opinion, some part of the relevant income or expenditure 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.

3.16 'Attributable' in this context has the same meaning as under the business profits article. The OECD Commentary on 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.[36]

3.17 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.

3.18 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.

3.19 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 Convention use the phrase 'effectively connected with'; in the case of Articles 10 to 12 this refers to the property giving rise to the type of income in question and in Article 21 to the income. Similarly, Article 13 of the Vietnamese Agreement on capital gains refers to property that forms part of the business property of a PE. In the ITAA 1936, 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). Notwithstanding this variety of expression, the same operating idea of attribution applies in these and similar cases.

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[36] OECD Commentary, Article 7, paragraph 5.

Source of income and allocation of expenditure

ITAA

3.20 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 in or out of Australia. The other alternative relates to expenditure incurred in deriving income sourced in or out of 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.

3.21 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.

3.22 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'.[37] 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

[37] 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.

is permitted even where apportionment would not be possible under judicial principles or other statutory provisions.[38]

DTAs

3.23 The OECD Model Convention does not generally utilise the notion of source in relation to allocation of taxing rights. Rather, it simply specifies the circumstances in which the country of 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*[39]. 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).

3.24 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 1.15 to 1.17 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[40] but has not been regarded as substantively different in effect.

Income and profits

3.25 A variety of terminologies are used in the ITAA and DTAs. The ITAA 1936 and ITAA 1997 have 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.

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[38] *Hillsdon Watts Ltd v. Commissioner of Taxation (NSW)* 57 CLR 36 at 48, 51-52 on an earlier provision in similar form.

[39] For example, Vietnamese agreement, Article 22.

[40] For example compare section 6-5 of ITAA 1997 and sections 38 to 43 of ITAA 1936).

ITAA

3.26 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). This includes net capital gains. Income according to ordinary concepts or statutory income which is exempt also comes 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.

3.27 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 of the ITAA 1997. The use of this term supports the view that notional income is not created by subsection 136AE(4)[41]. 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

3.28 In the business profits article of DTAs, the relevant term is usually 'profits of an 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 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

[41] See paragraphs 1.9 to 1.10 above.

assessed and paid by reference to the 'taxable income' of a taxpayer, not profit[42].

3.29 It is not considered that subsection 3(2) of the Agreement Act means that the usual calculation of taxable income as assessable income less deductions under section 4-15 of the ITAA 1997 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.

Expenditure

ITAA

3.30 The term 'expenditure' includes losses and outgoings[43]. Accordingly, section 136AE will impact on all the provisions of the ITAA that are concerned with losses and outgoings[44] and also those that are concerned with capital allowances and non-allowable items.

3.31 The phrase 'expenditure incurred in deriving income' is also a defined term[45] 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 of the ITAA 1997. 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 (e.g., charitable donations[46]) would be covered.

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

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42 See Explanatory Memoranda to Income Tax Assessment Bill 1947 at 52, Income Tax (International Agreements) Bill 1953 at 15.
43 Subsection 136AA(1).
44 Section 8-1 of the ITAA 1997.
45 Subsection 136AE(8).
46 Section 30-1 of the ITAA 1997.

DTAs

Paragraph 3

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

3.34 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 of the ITAA 1997. Some countries have strict rules preventing apportionment and denying deductions where expenditure does not relate entirely to income taxable in that country, but such rules cannot be applied in a treaty context to disallow expenditure which relates partly to a PE in that country.

3.35 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[47].

Only actual deductions allowed

3.36 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

[47] See *Utah Mines Ltd v. R* 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.

deductions of the taxpayer and uses the arm's length separate enterprise principle as a means of allocating income and expenditure. 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.

3.37 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.

3.38 It is suggested in paragraphs 17.4 to 20 of the OECD Commentary on Article 7 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).

3.39 Further work is occurring in the OECD in this area and the Ralph Report has recommended that Australia progressively introduce a separate entity treatment[48]. 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[49], and in other cases, to apply mark-ups or a profit element in arm's length transfer prices used in the allocation process[50]. 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

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48 Recommendation 22.11(a).

49 See the discussion of trading stock in Chapter 5 of this ruling.

50 See the discussion of startup and ending of a PE in relation to R&D expenditure at paragraph 3.61 and those following in this ruling.

in the PE area from the principles applied between separate enterprises.

3.40 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[51] are not affected by the business profits and double tax relief articles in tax treaties.

Attribution of interest expense

3.41 The following discussion relates to enterprises that are not financial institutions. Special considerations apply to the attribution of interest income and expense to PEs of financial institutions, and these will be discussed in a separate Ruling.

3.42 To the extent that funds borrowed by an entity are used in connection with the business carried on through its PE, the interest expense incurred by the entity on those borrowing's is attributable to the PE.

3.43 Intra-entity interest charges between a PE and its head office or another PE are recognised under Australia's PE attribution rules only for purposes of attributing to the PE interest expense of the entity on borrowing's from third parties. Thus, if the entity borrows funds through its head office and those funds are transferred to a PE for its use, a notional interest charge made by the head office to the PE may be recognised to attribute to the PE the amount of interest payable to the third party lender. On the other hand, if there is no actual interest cost to the entity attaching to the funds transferred (i.e., if the funds are internally generated rather than borrowed from a third party), then there is no interest expense to be attributed to the PE, and hence no notional interest charge can be recognised between head office and PE.

3.44 In determining the amount of an entity's interest expense that is attributable to its PE, two alternative approaches, or variations thereof, are commonly adopted. First, there is the "tracing approach", which seeks to connect the funds transferred to or used by a PE with their original provision by third parties. Alternatively, there is the

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

"fungibility approach", under which internal transfers of funds are ignored and the entity's pool of borrowed funds and associated interest expense are allocated amongst its parts using an appropriate "key" such as gross revenues or assets. The most appropriate approach in a particular case will depend upon the facts and circumstances, having regard to what is possible and practicable and is likely to give the most reliable and accurate attribution.

Capital (interest free funding)

3.45 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 such capital must be allocated to a PE.

Losses

ITAA

3.46 Given that subsection 136AE(4) allocates income and expenditure and operates across years of income,[52] a determination may produce 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.

DTAs

3.47 Similarly, the business profits article can apply to allocate a loss to a PE or to adjust a loss in a PE or to allocate a profit to a PE where the enterprise makes an overall loss.

3.48 The ATO considers that the reference to 'profits' in the article is not to be interpreted literally, so excluding losses. In cases where the applicable treaty has an 'Other Income' article[53], the result of such an interpretation would be that the relevant income would be picked up under that article, which would have the effect of putting the income effectively connected with the PE back into the business profits article.

3.49 In other cases, 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

[52] See paragraph 3.2 above.
[53] For example, Vietnamese agreement Article 21.

sections 6-5 and 6-10 of the ITAA 1997 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.

3.50 Indeed, 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 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.

3.51 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.

3.52 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[54] 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

3.53 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

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[54] *American Thread Co v. FC of T* (1946) 73 CLR 643.

exercise of the power to make a determination relating to the tax result of the adjustment.

3.54 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.

DTAs

3.55 The equation of business profits to taxable income in subsection 3(2) of the Agreements Act can have no relevance where profits are exempted from tax under section 23AH. 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

3.56 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, where an enterprise sells equipment through a PE it may incur losses under warranty claims made after the PE business is closed down.[55]

ITAA

3.57 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 income year to which the determination relates or 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.

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[55] Compare *Placer Pacific Management Pty Ltd v FC of T* 95 ATC 4459; 31 ATR 253. If the expense is not deductible under s 8-1 of the ITAA 1997 because it is regarded as having lost any relevant connection with the income, the issue discussed here will not arise.

3.58 In the case of section 23AH, the arguments for the existence of the PE when deriving foreign income to obtain the foreign branch 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)); and
- the tying of the exemption to periods of residence (subsection 23AH(2)) which links to the residence and source rules of section 6-5 of the ITAA 1997 (which require residence or non-residence to be tested in the year income is derived).

DTAs

3.59 The business profits article contains no specific timing link between the existence of the PE and the year when income is derived or expenditure incurred. Paragraph 11 of the OECD Committee on Fiscal Affairs, Commentary on Model Tax Convention on Income and Capital, OECD, Paris (loose leaf) (commentary on Article 5) 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 in applying the attribution test is whether the relevant income or expenditure arose from the activities of the PE, not whether the PE exists when the income or expense is brought to account for tax purposes[56]. The ATO adopts this view.

3.60 Hence, for example, a taxpayer could deduct warranty expenditure arising out of a PE's activities even after the PE closes down. Likewise, a taxpayer could include as income attributable to a PE after it has closed instalments under a contract to sell equipment if those instalments would be derived under domestic law in later years[57].

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[56] Vogel K., *Klaus Vogel on double taxation conventions: a commentary to the OECD-, UN-, and US model conventions for the avoidance of double taxation on income and capital, with particular reference to German treaty practice;* 3rd edition; Kluwer Law International, London, 1997, at page 410.

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

Research and development (R&D)

3.61 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. R&D is an example. Quite often firms spend large sums on R&D and, many years later, begin to derive significant income from that part of the R&D which proves successful. During these 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.

3.62 In this context, a number of possibilities for calculating PE income arise. The intellectual 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.

3.63 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 its 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

3.64 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).

3.65 In such cases, at least two questions arise. First, can income produced by the operations in a country when a PE exists be allocated to periods when the PE does not exist to reward other parts of the enterprise for 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 first question is covered by the discussion of 'asset allocations and capital allowances' in Chapter 5 of this ruling. The following example and discussion deals with the second question.

Example

3.66 A non-resident company, ForCo, leases an oilrig 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 wear or damage which occasioned the repairs occurred during a period when the equipment was not being used in 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 is wholly or partly deductible under sections 8-1 and 25-10 of the ITAA 1997. Having regard to the circumstances under which need for the repairs arose, 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 Australian exploration is completed. ForCo allows 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 of the ITAA 1997, 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 of the ITAA 1997 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.

3.67 Deductions available to a taxpayer under the repair provision may not be wholly attributable to its Australian PE due to the operation of the attribution rules. It may be difficult to establish 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 for assessable income purposes by the Australian PE, the whole of the repair expenditure will be attributable to it. 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 will *not* be attributable to the Australian PE, notwithstanding subsection 25-10(1) of the ITAA 1997. It is considered that apportionment in this context is different to that under section 25-10 of the ITAA 1997 and Taxation Ruling TR 97/23 dealing with deductions for repairs generally because they do not involve questions of attribution.

3.68 Where it cannot be established that the need for repairs arose solely in relation to the use of the asset for assessable income purposes by the Australian PE, a reasonable apportionment of the repair expense will be needed . Relevant factors in making this apportionment may include:

- the date of the last repair expenditure;
- where there has been no prior repair expenditure by the entity, the date of purchase of the asset by the entity; and
- whether and to what extent an identifiable incident gave rise to the need for repair.

3.69 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 its use for assessable income purposes, the insurance receipt will be attributable to the Australian PE to the same extent as the repair expenditure.

Chapter 4: Methodologies

Introduction

4.1 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 or 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.

4.2 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.

4.3 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.

4.4 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.

4.5 Obviously, practical difficulties can arise in relation to 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

4.6 It is normal commercial practice for some form of separate accounts to be kept for a PE. These may treat internal transfers as if they were transactions with external parties. Where separate accounts have been prepared in accordance with proper accounting practice they may be a starting point for constructing an economic model of the PE for tax attribution purposes, depending on the segmentation adopted and the characteristics to be attributed to the PE.

4.7 The process of segmenting an entity for management accounting and tax purposes may potentially be aligned, and viewed in three stages.

Stage 1: Identify the segments

4.8 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.

4.9 For taxation purposes, the activities carried on in and out of Australia must be separated; the PE needs to be regarded as a segment. Given that a PE is a geographically distinct operation, it will commonly be a separate segment under a MNE's organisational structure and accounting framework. However, in an e-commerce environment it may not make sense for management purposes to view performance of some forms of business on a geographically segmented basis. In this situation, attribution may require development of a sophisticated contribution analysis for allocation of 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.

Stage 2: Assemble financial data for segments

4.10 Next, data must be assembled in relation to the income, expenditure and assets and liabilities on a segment basis. To a large extent, the segment accounting framework will determine how items are allocated and apportioned. The policies and procedures will be primarily designed to supply management with adequate reliable information for decision making, accountability for resources, control and evaluation of performance. The allocation process will tend to be governed by the nature of each segment's business activities and a nexus to its transactions. Sales income 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.

4.11 Essentially the same process is involved for taxation purposes, as 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.

4.12 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, there would need to be adjustment 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.

Stage 3: Determine inter-segment charges

4.13 This completes the matching of income and expenditure at the segment level. At this stage 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.

4.14 For taxation purposes this stage 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.

4.15 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 and characteristics of the PE, including assets, risks and financing? If not, then it will be necessary to adjust or construct PE accounts or undertake a detailed contribution analysis, to serve as a basis for the economic modelling of the PE;
- Do the segment accounts allocate actual income, expenditure and other items correctly having regard to the functions carried out, the assets used and the risks assumed? If not, what is 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?; and
- What methodology has been used for calculating the inter-segment charges? Is the methodology appropriate and are the calculations correct?

4.16 After possible correction to segment accounts for primary allocation issues, the valuation of intra-entity dealings is at the heart of the attribution issue. Treating intra-entity dealings as analogous to

separate entity dealings enables the use of accepted arm's length transfer pricing methodologies.[58]

A Structured Process for Modelling Attribution Issues

4.17 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.

4.18 The questions raised in paragraph 4.15 can be answered through an adaptation of the four step process set out in Taxation Ruling TR 98/11, 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 process then follow, also with adaptations appropriate to 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 both tax authorities concerned.

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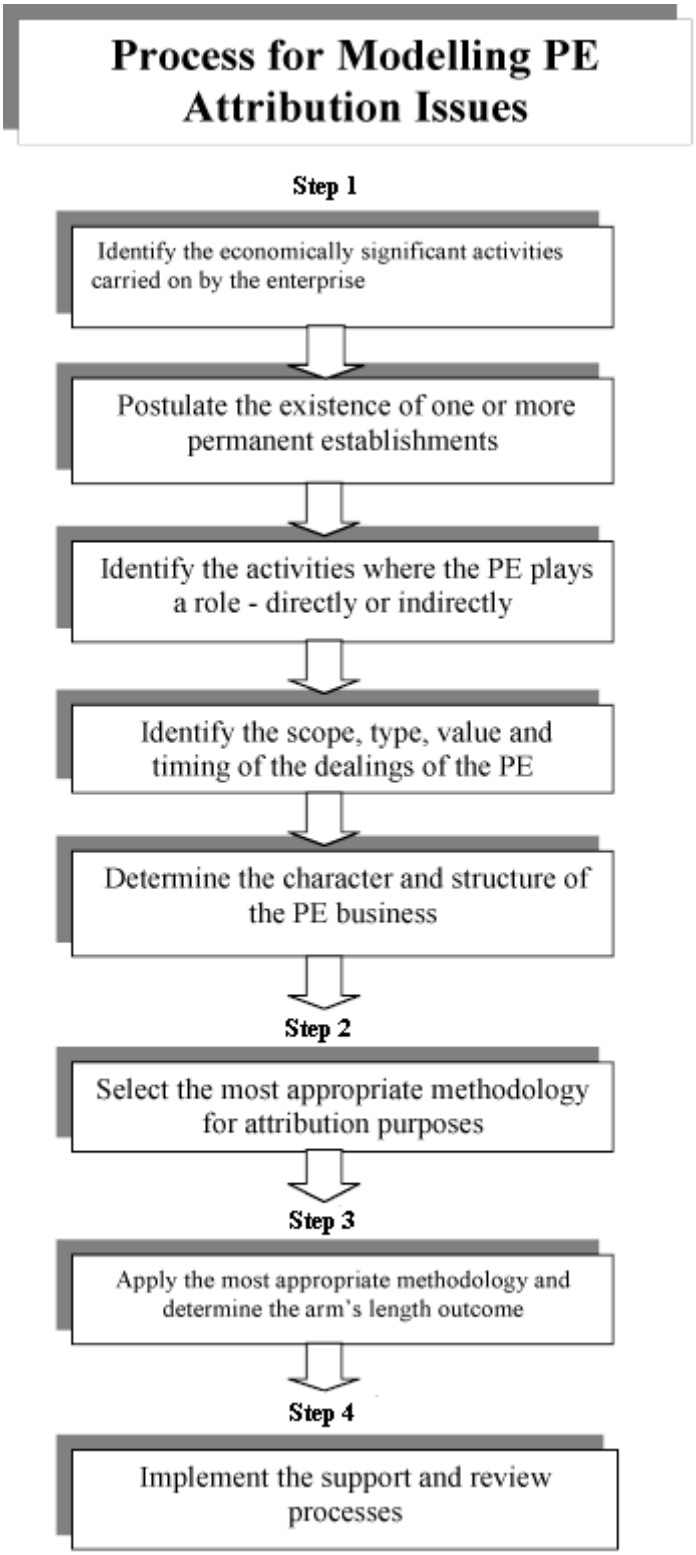
58 Refer Taxation Ruling TR 97/20 paragraphs 3.5 to 3.9.

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



4.20 The process suggested here as a guide is essentially iterative, like the four steps.[59] 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[60] 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.

4.21 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) structure 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.

4.22 The modelling of the PE must be consistent with the relevant ITAA and DTA definitions of the term PE. 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.

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59 See Taxation Ruling TR 98/11 paragraphs 5.1 to 5.16.

60 See Taxation Ruling TR 97/20 paragraph 2.32.

Step 1.1: Identify the economically significant activities of 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 Business objectives, strategies adopted Financial performance Conditions in each relevant market (e.g., competition, regulatory factors) Dealings with associated entities	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 Link risks and their management to activities Link information flows to activities

4.23 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. This 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. 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. It is necessary to examine the PE relationships over time, to identify the economically significant activities[61] 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. Attention should be paid to the discretion afforded the management of the potential PE to act independently in

61 See Taxation Ruling TR 98/11 paragraphs 5.48 to 5.51.

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.

4.24 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. It may be helpful to consider the implications of three distinctive patterns in the way value is created by enterprises:

(1) Creating value through the transformation of inputs into outputs

This pattern includes most manufacturing enterprises where value creation is sequential. The primary activities may include inbound logistics, operations, outbound logistics, marketing and service.

(2) Creating value through knowledge based problem solving

This pattern delivers value by mobilising knowledge based resources and focussing the activities of the enterprise so as to solve unique customer problems. Professional service firms, resource exploration firms, research and development firms, hospitals and educational enterprises are examples. The primary activities may include problem finding and definition, problem solving, choice of action, execution of a chosen solution and control.

(3) Creating value through access to and the utilisation of networked resources

This pattern delivers value by facilitating network relationships among customers using a mediating technology. Examples include telecommunication companies, transport, insurance and banks. 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. It is also possible that an enterprise may create value through more than one of these distinctive patterns.

4.25 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

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.

4.26 To apply the arm's length principle, 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.

4.27 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.

4.28 Specific issues regarding the existence of a PE may arise under Article 5 of the OECD Model Convention, 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.[62] 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.

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62 Refer OECD commentary on Article 5 at para 24.

Step 1.3: Identify the activities where the PE plays a role

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

4.29 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.

4.30 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.

4.31 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).

4.32 For each activity involving the PE 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.

4.33 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 modeling will depend on the circumstances.

4.34 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.

4.35 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. In a start-up situation, a head office is not treated as if it had transferred an idle or newly acquired asset by way of sale, cost contribution arrangement or lease to the PE on its establishment. The treatment of a change in use of a productive asset owned by an entity (e.g., transfer of the asset from head office to PE) is discussed at paragraphs 5.17-5.21 below.

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

4.37 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.

4.38 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 4.33 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,[63] 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.

63 See paragraph 4.37.

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 and legislative requirements in each jurisdiction	Determine 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	Determine 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)	Determine 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	Apply income and expenditure tests (section 136AE)
	Decide if aggregation over time or dealings is possible or necessary
	Determine if there is more than one PE

4.39 If the PE maintains separate accounts, it must be decided whether the transactions and dealings reflected in those accounts are to be accepted as a true reflection of the economic activity. In some cases it will be necessary in building an economic model of the PE to create accounts where none exist or to adjust existing accounts in order to reflect the application of the arm's length principle to the postulated separate enterprise.[64]

64 Refer Chapter 5.

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 separate enterprise analogies. Determine the capital structure or other characteristics the business may have if carried on by an independent enterprise.

4.40 This step links the PE analysis to that for associated enterprises embodied in existing rulings[65]. Where the parties involved are legally distinct entities, the comparability analysis needed to establish the arm's length character of dealings 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.[66]

4.41 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 constructing an economic model of the PE is to identify an appropriate "separate enterprise analogy" for which appropriate arm's length methodologies exist and to use this in determining taxable income.

4.42 Some relevant separate enterprise analogies include:

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

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[65] See Taxation Rulings TR 94/14, 97/20 and 98/11.

[66] See Taxation Ruling TR 97/20 paragraphs 2.28.

- Manufacturer - distributor relationship

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 transfer pricing methodology to apply overall or to specific categories of dealings Document process

4.43 The use of some of the accepted transfer pricing methods (e.g., Comparable Uncontrolled Price (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 an associated dealing with a third party.

4.44 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 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	Perform comparability analysis Assess reliability Decide on the arm's length outcome, applying more than one method if necessary

4.45 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

4.46 A taxpayer carrying on business through a PE must keep records evidencing the basis upon which, for tax purposes, income, expenditure, assets, liabilities and capital are allocated and profits attributed to the PE.[67]

4.47 In reviewing the appropriateness, in terms of the business profits article and subsection 136AE(4), of a taxpayer's calculations of PE income and expenditure or profit, the ATO will seek to rely as much as possible on documentation created by the taxpayer in the

[67] See section 262A.

ordinary course of conducting its business. Where separate accounts are maintained for the PE and these reflect the true economic substance of the PE's dealings, the amounts recorded in the accounts will be the starting point when the ATO evaluates whether a taxpayer's allocation of income, expenditure, assets, liabilities and capital to a PE and the resulting attributable profit is appropriate.

4.48 The ATO expects taxpayers to keep documentation to show that the process used for calculating PE income and expenditure or profit properly addresses the considerations in the business profits article and subsection 136AE(4), including the arm's length principle, and that their tax returns have been prepared on that basis.

4.49 Where a taxpayer has 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 to achieve the correct attribution result for tax purposes will need to be made when preparing its tax return.

4.50 Ideally, the process for determining PE income, expenditure, assets, liabilities and capital, and profit should be modelled on that described above.[68] The table for each step indicates the information required and the documentation that should be prepared and retained. The documenting of a functional analysis is ordinarily a critical part of this process.

4.51 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. These are relevant to intra-entity dealings to the extent that the processes involved in selecting and applying the accepted arm's length pricing methodologies are relevant to those dealings.

Examples

Example 1: Functional Analysis - Installation Project

4.52 Supernet Company Limited (SCL) is a MNE incorporated in the United States of America, 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.

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[68] Refer paragraphs 4.17 to 4.45.

4.53 SCL wins a contract to construct a global telecommunications network on behalf of a third party. The 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$100M for the successful completion of the project. Of this amount, payments totaling A$22 million are allocated under the contract for the completion of the Australian link in the network.

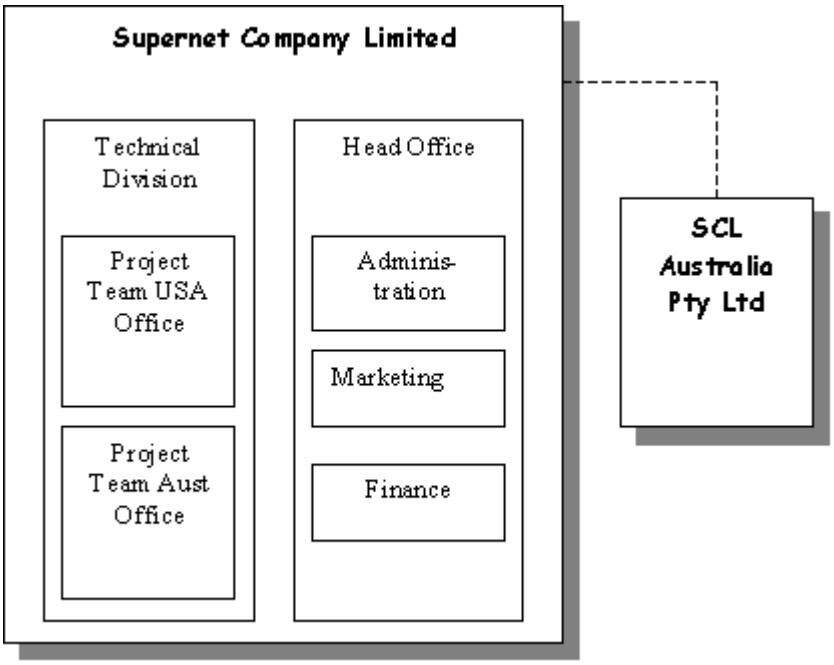
4.54 The completion of this global contract will take three years, with the Australian installation being the first and taking approximately twelve months. A department in the Technical Division of SCL has been specifically created to oversee the development, installation and testing of this infrastructure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

4.55 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$15 million). SCL's primary role will be to supervise the construction and test the installation of equipment situated in Australia.

4.56 To perform this role, SCL establishes a rented office near the construction site. The office is staffed by a local manager and two 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 government requirements. The local office also provides 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.

4.57 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 to include two engineers and a small laboratory 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.

4.58 The above arrangements may be illustrated as follows:



4.59 An initial assessment of the functions performed by the SCL segments in USA and Australia 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

4.60 Assume that SCL has a sufficient presence in Australia during both the construction and testing phases that a PE exists for the duration. The PE consists 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.

4.61 The core activities of SCL personnel in Australia and the USA for the project relate to 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.

4.62 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 installments 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.

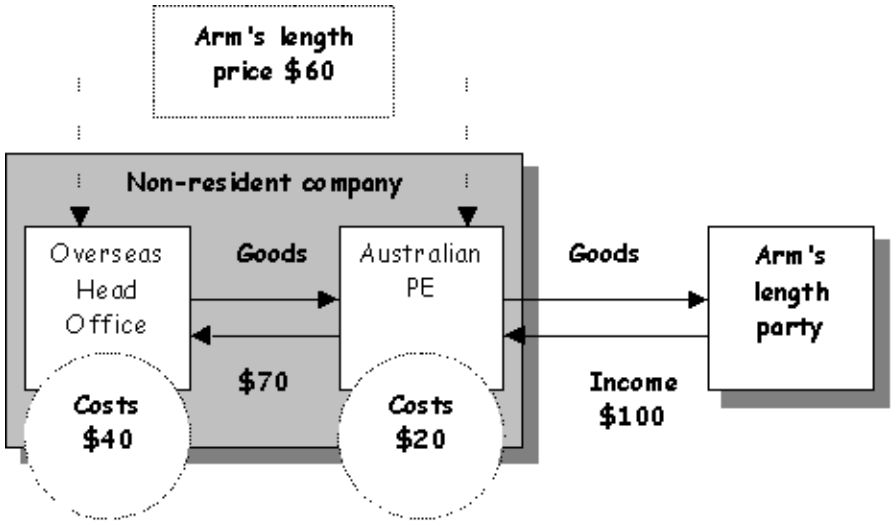
4.63 Another consideration for choosing and implementing a service provider approach that will be apparent from the above overview of functions, assets and risks is that the search for comparables may be affected by some important aspects of assets employed and risks present. Some assets (particularly 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.

4.64 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.

4.65 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. A possible argument 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 ($22 million) and the tender price under the construction and installation contract ($15 million) could be a starting point for the profit calculation if those amounts are the arm's length values.

Example 2 - Use of accepted transfer pricing methodologies to allocate income and expenditure to PEs

4.66 Widgets'R'Us Limited (WRL) is a MNE incorporated in Thailand whose business is the manufacture and sale of widgets. Widgets for sale in the Australian market are manufactured to a partly finished state by WRL's Thailand head office at a cost of $40 per unit, imported into Australia and, after some additional manufacturing, sold by an Australian branch office (PE) to arm's length customers for $100 per unit. The transfer price recorded in WRL's accounts (at the time of transfer) is $70 per unit. The Australian PE sells the goods to customers after additional manufacturing and selling costs of $20 per unit are incurred. WRL has derived an overall net profit of $40 per unit, of which $10 has been allocated in its accounts to the Australian PE and $30 to its 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**

4.67 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.

4.68 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.

4.69 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. 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.

4.70 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.

4.71 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 assuming that $60 reflects an appropriate transfer price at the time the goods are transferred between head office and PE, that amount 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 break-even result.

4.72 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. This situation is likely to be rare in practice. Moreover, the principles concerning aggregation of transactions[69] 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 5 Application

Introduction

5.1 The previous chapters have set out the view that Australia's PE 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.

5.2 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.[70]

5.3 One source of issues is that the enterprise is likely to maintain its records on a whole of enterprise and segment basis but not containing 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.

5.4 Another source of issues is that, unlike separate enterprises, the PE and head office will not enter into actual transactions which

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[69] See Taxation Ruling TR 97/20 paragraphs 2.73 to 2.82.

[70] See Taxation Ruling TR 97/20 paragraphs 3.88 and 3.89.

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 Committee on Fiscal Affairs, OECD *Transfer Pricing guidelines for multinational enterprises and tax administrations*, OECD, Paris, 1995, 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.[71] 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.

Trading stock

5.5 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 of 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.

5.6 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.

5.7 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.

5.8 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.[72] The value of trading stock at the

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[71] OECD Commentary, Article 7, paragraphs 12 and 12.1.
[72] Section 70-45 (ITAA 1997).

start of the year of income is the same amount as its value at the end of the previous income year.[73]

5.9 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 first in, first out (FIFO) or average cost, being the generally accepted methods under Australian tax law.

5.10 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 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.

5.11 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.

5.12 The following basic accounts may be constructed:

[73] Section 70-40 (ITAA 1997).

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**

5.13 We can see from this simple scenario that no profit has been realised by the entity 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.

5.14 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.

5.15 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.

5.16 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 last in, first out (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.[74] 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.

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[74] See Recommendation 22-11(a).

Asset allocations and capital allowances

5.17 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 transfer to be treated as a sale, a lease or something else?

5.18 International transactions involving tangible and physical goods or assets are so varied and complex, even where involving independent parties[75], 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).

5.19 The Canadian case of *Cudd Pressure Control Inc*[76] indicates the difficulty in addressing the key issue, i.e., whether, in the particular facts and circumstances, an independent enterprise would have purchased or rented the asset. There, a non resident company provided its own equipment for carrying out services on an offshore drilling rig of a Canadian resident. The carrying out of the services created a Canadian PE of the non-resident. In calculating the profits of the PE, the taxpayer deducted notional rent for the PE's use of the equipment, arguing 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 there was no basis for interfering with the judge's finding of fact that the PE, treated as an independent enterprise, would not have rented the equipment from the head office, with a more reasonable assumption being that the PE would have purchased the equipment.

5.20 Where there is a change in use of a productive capital asset (e.g., machinery or equipment is moved from a head office to a PE), how this intra-entity dealing is characterised will depend upon the facts and circumstances surrounding the change in use. Whether the appropriate separate enterprise analogy for the dealing is a sale, lease or something else will be determined by considering such questions as: when was the asset originally acquired?; did the PE exist at that time?; what is the history of the asset's use by the entity?; how does

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75 See Taxation Ruling TR 98/21 re Cross Border Leasing.

76 See notes 17 and 18 to this ruling.

the entity use such assets in its business?; how important is the asset to the PE's business?; is the PE's use expected to be short term/temporary or long term/permanent/indefinite?; has the PE assumed risks associated with use and effective ownership (e.g., responsibility for repairs, maintenance, risk of loss from destruction or obsolescence)?

5.21 Where the intra-entity dealing is treated as a lease, a notional arm's length rent is used to allocate, between PE and head office, income derived from the PE's use of the asset. If the PE is in Australia, this reduction in the entity's assessable income requires a corresponding apportionment of any capital allowance deduction. On the other hand, where the intra-entity dealing is treated as comparable to a sale, any depreciation deduction related to the PE's use of the asset is wholly attributed to the PE.

Capital allowances under Australian law

5.22 In *Cudd Pressure Control Inc,* the capital cost allowance was calculated using the market value of the equipment at the time it was brought into Canada and depreciation deducted based on that value. This was required under a specific provision in Canada's taxation laws. This would not be acceptable under Australian taxation law.

5.23 Where the Australian PE of a non-resident entity is the user of a depreciating asset of the entity, a deduction for its decline in value is available under Division 40 of the ITAA 1997 in determining the attributable profits of the Australian PE from the time the plant is used to produce assessable income.

5.24 Subdivision 40-C of the ITAA 1997 provides that the deduction available is based on the cost of the depreciating asset to the taxpayer, with this being established under sections 40-180 and 40-190 of the ITAA 1997. Often, this will equate to the original (or historical) cost of the asset. Where the diminishing value method is used for calculating the allowable deduction (section 40-70 of the ITAA 1997), the original cost of the asset is reduced by its decline in value in relation to the period of holding or use for non-assessable income purposes, and this reduced value is used to calculate the deduction allowable when use commences for assessable income purposes (section 40-85 of the ITAA 1997).

5.25 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 depreciating assets, including the oil rig, are used during the Australian operations of the PE. These assets are already owned by ForCo and in productive use and are transferred to the PE at the commencement of the Australian operations. In all of the

circumstances, it is determined that the appropriate separate enterprise analogy for the intra-entity dealing is a lease.

5.26 A deduction is allowable under Division 40 for the decline in value of these depreciating assets to the extent of assessable income attributed to the PE (i.e., net of a notional arm's length rent for the assets). The original cost of each asset used by ForCo prior to the establishment of the Australian PE, will be reduced for the period of time from original acquisition of the asset by ForCo to the time when the asset was transferred to the Australian PE. This reduced value is used to calculate the capital allowance deduction allowable to the Australian PE. In general, this position effectively distributes the actual cost of asset over its life 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 asset at the point that it was transferred to the PE.

Services

5.27 Activities in the nature of 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 business 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.

5.28 In general terms, and subject to the specific matters discussed below, the principles stated in Taxation Ruling TR 1999/1 with respect to charging for services provided between separate legal entities will apply, by analogy, in the PE context. While no deductible charge can be incurred and no assessable amount derived in respect of services provided between a PE and head office, the arm's length separate enterprise principle calls for regard to be had to such services as if the PE were a separate independent entity for purposes of attributing the enterprise's income, expenditure or profit between head office and PE.

5.29 In the separate entity context, the first issue, according to TR 1999/1, is whether chargeable services have been supplied. This is determined by applying a "benefit test", i.e., by considering whether the relevant activity has provided something of economic or commercial value that an independent entity might expect to pay for or to obtain payment for supplying.

5.30 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 another. 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 is to be taken into account as an interbranch dealing of economic significance for the purposes of attributing income, expenditure or profit.

5.31 The concept of shareholder activities[77] is applicable by analogy in the PE context. Activities performed at a head office or by another member of the MNE group that would not be regarded as benefiting the PE were it a separate and independent enterprise should not give rise to an attribution of income, expenditure or profits between the PE and head office or other group member. While a head office does not act in the capacity of a shareholder in other parts of the entity, monitoring or oversight functions it performs may be analogous to those undertaken by a parent company in such a capacity in a MNE group context. Also, costs such as those relating to maintaining the company's share register, company shareholder meetings, and company statutory reporting requirements in its home country should not be attributed to a PE. However, where the head office performs an activity for the entity from which a PE derives benefit, then this is a chargeable service, not a shareholder activity. An example would be where the head office of a bank performs statutory requirements in the home country which are then used to satisfy local requirements in the country of a PE. Importantly, shareholder activities must be distinguished from centralised management or administrative activities performed by a parent/head office or other group member in its role as a service provider for the intended benefit of the MNE group as a whole.

5.32 Having found a rendering of intra-entity services, the arm's length value of those services may be a sound way of attributing income, expenditure or profit between a head office and PE, particularly where the services are of the substantial kind identified in paragraphs 17.5 and 17.6 of the OECD Commentary on Article 7. To establish the arm's length amount the same methodologies (most commonly '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.

5.33 TR 1999/1 prescribes administrative practices for 'non-core' services and *de minimis* cases[78] under which the ATO will not exercise its discretion to adjust transfer prices for services between

[77] See paragraphs 25-27 of TR 1999/1.
[78] See paragraphs 75-102 of TR 1999/1.

separate entities to strictly accord with arm's length prices. However, these practices are not applicable in a PE context.

5.34 The OECD Commentary on Article 7 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.[79]

5.35 While this may be the general 'rule', the commentary on Article 7 recognises that where the service functions are substantial in the context of the entity's 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.[80]

5.36 Pending any future relevant developments in OECD views or Australian law, an allocation of costs approach is to be adopted for general management or administrative intra-entity services even though, if such services were provided 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.

Deemed PEs

5.37 Both domestic law and treaties include in the definition of PE a number of specific situations in which activities of a third party give rise to a PE. In cases of such deemed PEs, issues arise of separating the profits of the third party and the PE and of applying the arm's length separate enterprise principle.

5.38 For example, an agent with power to contract is treated as a PE of the enterprise in certain situations.[81] The enterprise will be earning income through the activities of the agent and paying the agent for its services. Under the arm's length separate enterprise principle it could be argued that the PE makes no profit. Using this argument, 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 an arm's length agent's fee because this is all that an independent party would have received for the activities carried on by the enterprise in the jurisdiction. The fee paid to the agent will be an expense of the

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[79] See paragraph 17.7 of the OECD Commentary.

[80] See paragraphs 17.5 and 17.6 of the OECD Commentary.

[81] 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.

enterprise attributable to the PE, with a nil tax result. On this view, if the agent is rewarded with a less than arm's length price for its services, the profit of the agent may be able to be adjusted to an arm's length amount using provisions relating to separate enterprises[82]. Alternatively, an adjustment could be made to increase the income or profit 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 alternative, though the tax collected may differ due to the different tax position of the agent and PE (tax rates, carry-forward losses etc).

5.39 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, 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 ..."[83] The limited right to tax which follows from the argument outlined above does not accord with this plain statement in the Commentary. 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 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.

5.40 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.

5.41 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

[82] Section 136AD or the associated enterprises article (Article 9) of the Vietnamese agreement.
[83] Paragraph 31.

person processes goods on behalf of another[84]. 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. Adjustments under domestic and treaty provisions dealing with separate enterprises could be made 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 on the basis of similar reasoning to that used in relation to the agency PE.

5.42 Where third parties are involved in substantial equipment PEs,[85] 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,[86] 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 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 any capital allowance deductions allowable.[87] 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.[88]

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[84] See paragraph (d) of the definition in subsection 6(1) and paragraph 5 of Article 5 of the Vietnamese agreement.

[85] Section 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."

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

[87] See also paragraphs 3.66 to 3.69 above as to expenses of offshore repairs and downtime.

[88] Compare *Cudd Pressure Control Inc*, paragraph 5.19 above.

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