

# NSW Tax Forum

## Session 12B: Permanent Establishments: Practical considerations on what could create a taxable presence outside of your place of incorporation

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# 1. Overview

While mobile workforces, globalisation and Permanent Establishments ('PE') are not new concepts, businesses are having to now re-focus on what could create a PE with the re-opening of borders and 'work from anywhere' flexible working arrangements. The PE threshold can create income tax obligations for an enterprise outside of its place of incorporation, but are also relevant for the purpose of other Articles in a DTA, including withholding tax, taxation of capital gains, taxation of employment duties, other income and the non discrimination article.

In light of the importance of establishing a PE, this paper discusses the definition of a PE from an Australian domestic law and OECD perspective, but more importantly addresses a number of common scenarios or questions that may lead to a PE. The scenarios and questions include what is a fixed place of business, including consideration of shared offices and home offices, the use of contractors or employers of record versus employees, what is the preparatory or auxiliary character exemption, what is a dependent agent and if the creation of a website will create a PE. Finally, this paper discuss the implications of creating a PE for Australian taxpayers, including comparison of the two profit attribution methods and the implications for inbound and outbound PEs.

While the contents of this paper considers Australia's domestic legislation, ATO rulings, Australian case law and OECD commentary and guidelines, multinationals should seek advice specific to the facts and circumstances of its own operations to establish if it has a taxable presence outside of its incorporation.

## 2. Common Abbreviations

Abbreviations	Terms
Agreements Act	International Tax Agreements Act 1953
DTAs	Double Taxation Agreements
FBT	Fringe Benefits Tax
ITAA 1936	Income Tax Assessment Act 1936
ITAA 1997	Income Tax Assessment Act 1997
MLI	Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting
MNEs	Multinational enterprises
Model commentary or Commentary	Commentaries included within the OECD Model Convention With Respect To Taxes On Income And On Capital (2017)
OECD	The Organisation for Economic Co-operation and Development
OECD Model or Model	OECD Model Convention With Respect To Taxes On Income And On Capital (2017)
PAYG	Pay As You Go
PE	Permanent Establishment

## 3. Australia's PE Rules

### 3.1 Australia's Domestic Law Definition

In assessing whether a business has a taxable presence outside of its place of incorporation, the domestic law definition of PE should always be considered before considering case law, rulings or OECD materials. Subsection 6(1) ITAA 1936 defines a PE as follows:

*"in relation to a person (including the Commonwealth, a State or an authority of the Commonwealth or a State), means a place at or through which the person carries on any business and, without limiting the generality of the foregoing, includes:*

*(a) a place where the person is carrying on business through an agent;*

*(b) a place where the person has, is using or is installing substantial equipment or substantial machinery;*

*(c) a place where the person is engaged in a construction project; and*

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

*but does not include:*

*(e) a place where the person is engaged in business dealings through a bona fide commission agent or broker who, in relation to those dealings, acts in the ordinary course of his or her business as a commission agent or broker and does not receive remuneration otherwise than at a rate customary in relation to dealings of that kind, not being a place where the person otherwise carries on business;*

*(f) a place where the person is carrying on business through an agent:*

*(i) who does not have, or does not habitually exercise, a general authority to negotiate and conclude contracts on behalf of the person; or*

*(ii) whose authority extends to filling orders on behalf of the person from a stock of goods or merchandise situated in the country where the place is located, but who does not regularly exercise that authority;*

*not being a place where the person otherwise carries on business; or*

*(g) a place of business maintained by the person solely for the purpose of purchasing goods or merchandise.*

*Note: Subsection (6) treats a person as carrying on, at or through a permanent establishment that is a place described in paragraph (d) of this definition, the business of selling the goods*

*manufactured, assembled, processed, packed or distributed by the other person as described in that paragraph”.*

It is clear from the domestic law definition that to create a PE, a taxpayer must satisfy the following limbs:

- one must be carrying on a business; and
- the business must be carried at or through a place in that country.

While the definition provides examples of circumstances that could create or not create a PE, the subjective nature of the domestic legislation definition PE is contingent upon a multitude of factual and circumstantial considerations. As a result, multinationals operating in Australia must consider the court's interpretation and the Commissioner's interpretation in its rulings, some of which are discussed further below.

## 3.2 Relevant Australian Case Law

While there are numerous Australian cases that have ruled on Australia's taxing rights on multinational groups operating in Australia, the Unisys<sup>1</sup> and McDermott Industries<sup>2</sup> cases are particularly relevant in interpreting the PE definition.

### 3.2.1 Unisys Case

The Unisys case allows multinationals to draw on the following conclusions in assessing if it has a PE:

- The storage and retrieval of documents is not considered to be a business activity.
- Even if a multinational group has a fixed place of business in another country, for example, by holding an exclusive right to use leased rooms, a business activity must be actively carried on in that place in order for the fixed place of business to satisfy the PE definition.
- The mere existence of a general authority to conclude contracts will not in itself satisfy the dependent agent definition as there needs to be sufficient repetition of contractual activity to constitute the habitual exercise of a general authority to negotiate and conclude contracts.

### 3.2.2 McDermott Industries Case

In assessing whether the use of substantial equipment in Australia may create a PE, a multinational group can draw the following conclusions:

- This “use” of substantial equipment can include:
  - o The use of substantial equipment by an enterprise in another country;
  - o The use of substantial equipment “for” the enterprise; and
  - o The use of substantial equipment under a contract with the enterprise.

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<sup>1</sup> Unisys Corporation Inc v. FC of T 2002 ATC 5146; (2002) 51 ATR 386; [2002] NSWSC 1115 (otherwise referred to as *the Unisys case*)

<sup>2</sup> McDermott Industries (Aust) Pty Ltd v FC of T 2005 ATC 4398 (otherwise referred to as *the McDermott Industries case*)

- A non resident may have a PE in Australia if it leases substantial equipment to a lessee in Australia.

Whilst McDermott Industries ruled in the context of the Singapore/ Australia DTA, Taxation Ruling TR 2007/10 provides further guidance to multinationals in the following scenarios:

- The lessor is resident in a country to which Australia has no DTA (and thereby considering Australia's domestic law only);
- The lessor is resident in a country to which Australia does have a DTA and it's PE definition in relation to the use of substantial equipment is similar to the Singapore/ Australia DTA; and
- The lessor is a resident in the United States, United Kingdom or Norway (where there is a different interpretation of the use of substantial equipment creating a PE).

It should be noted that, in accordance with Taxation Determination TD 2007/31, the leasing of equipment for use in Australia in a hire purchase arrangement will not in itself create a PE in Australia for the non resident lessor.

### 3.3 Australian Tax Rulings

#### 3.3.1 TR 2001/13<sup>3</sup> and TR 2001/13A1 + A2 - Addendums

Taxation Ruling TR 2001/13 provides guidance in interpreting Australia's DTAs and its interaction with Australia's domestic law. The ruling explains how taxing rights are allocated for different categories of income between two countries that have concluded a DTA, and how distributive rules are allocated on the basis of "shall be taxable only" (exclusive taxing right) or "may be taxed" (non-exclusive taxing right). TR 2001/13 confirms that countries may choose not to exercise a taxing right and that a DTA may expand the domestic law. In the event that both countries have the right to tax the income, the ruling explains how DTAs relieve double taxation in the event of dual residence and dual source cases.

TR 2001/13A1 addendum issued in 2016 amends the original ruling as a result of the withdrawal of Taxation Ruling TR 2001/12 (capital gains in pre-CGT tax treaties). The TR 2001/13 A2 issued in 2020 makes a number of changes including references to the MLI and Australia's more recent international tax cases, including the Chevron transfer pricing case and Bywater Investments residency case.

#### 3.3.2 TR 2002/5<sup>4</sup> and TR 2002/5A3 – Addendum

Taxation Ruling TR 2002/5 outlines the Commissioner's interpretations of the meaning of the phrase *"a place at or through which person carries on any business of permanent establishment"* in the definition of PE in subsection 6(1) ITAA 1936. The ruling establishes that in order for a place to be considered as used for carrying on that person's business activities, it must have geographic and

<sup>3</sup> TR 2001/13 *Income tax: Interpreting Australia's Double Tax Agreements*

<sup>4</sup> TR 2002/5 - *Income tax: Permanent establishment - What is 'a place at or through which [a] person carries on any business' in the definition of permanent establishment in subsection 6(1) of the Income Tax Assessment Act 1936?*

temporal permanence.<sup>5</sup> With the exception of extraordinary circumstance, paragraph 33 of TR 2002/5 considers “temporal permanence” as satisfied where “*a business operates at or through a place continuously for six months or more that place will be temporally permanent*”.

The ruling was updated in May 2021 in TR 2002/5A3 to acknowledge the impact of the COVID-19 pandemic as an “extraordinary circumstance”. As a result of such extraordinary circumstance, a forced presence of employees in Australia for more than six months may not necessarily satisfy the temporal permanence requirement as stated below:

*“It is also conceivable that in some limited circumstances, a period of six months or more might not constitute temporal permanence, however the Commissioner considers this would be likely to occur in only the most extraordinary of circumstances. For example, the international travel restrictions and government-mandated lockdowns globally during the COVID-19 pandemic resulted in many businesses having employees present in Australia when they would ordinarily have been located outside of Australia, and many employees were typically required to continue their employment under ‘working from home’ arrangements. While temporal permanence remained a question of fact and degree in each case, the extraordinary circumstances of the COVID-19 pandemic presented some situations in which a forced presence in Australia for more than six months was considered temporary.”*

### **3.4 Interaction of Australia’s Domestic Law with DTAs**

As cross-border working arrangements become more prevalent in the post-pandemic world, it is important to consider the applicable DTA in determining whether the presence of employees in a particular country could trigger a PE for the employer.

Under section 5 of the Agreements Act, all Australian DTAs are given the force of law and are incorporated as a schedule to that Act. This incorporation confers legal enforceability on the terms of DTAs in Australia. Where there are possible conflicts between those DTAs and domestic law, subsection 4(2) of the Agreements Act effectively provides that the terms of the DTAs override those of Australia’s domestic law. However, this overriding effect is not absolute, and the Act provides for some limited exceptions. Undershaft’s case confirmed that while DTAs override Australia’s domestic law, “*a DTA does not give a Contracting state power to tax, or oblige it to tax an amount over which it is allocated the right to tax by the DTA. Rather, a DTA avoids the potential for double taxation by restricting one Contracting State’s taxing power*”.<sup>6</sup>

Australia’s DTA’s are negotiated using the OECD Model as a basis to allocate taxing rights and the OECD’s commentary can be used to interpret these DTAs.

#### **3.4.1 OECD Model and its Commentaries**

The OECD has developed a model convention with respect to taxes on income and on capital as a means of settling on a uniform basis the issues arising in the field of internal juridical double taxation.

<sup>5</sup> Both of which are discussed in section 4.1.1 and section 4.1.2 of this paper

<sup>6</sup> Undershaft [2009] FCA 41, 11(4) ITLR 652, paragraph 461

The Model is further interpreted by the commentaries, which the member countries should confer to and follow when negotiating and interpreting the provisions of a DTA.

When analysing a DTA, there may be instances where the interpretation of certain provisions may lead to uncertainty. In Australia, *TR 2001/13 Income tax: Interpreting Australia's Double Tax Agreements* paragraph 108 establishes it is appropriate to consider the OECD guidelines in interpreting a DTA. In situations where there is ambiguity or uncertainty in interpreting DTAs in terms of determining PE or allocating PE profits, the OECD Model and commentaries can be a valuable resource for providing clarity and ensuring consistency in the application of tax treaties. According to paragraph 36 and paragraph 36.1 of OECD Model introduction, it is recommended that the later versions of the OECD and the Commentaries should be considered when interpreting the earlier DTAs, as the meaning of the OECD and the Commentaries has been clarified, not changed, over the past amendments. The most recent OECD Model update was November 2017 and therefore the 2017 version should be analysed in interpreting the DTAs.

The relevant articles in the Model for taxation of PEs include Article 5 and Article 7. While Article 5 plays a crucial role in determining if a PE exists in another state, Article 7 explains how multinational groups should calculate the business profits attributable to that PE in the other state. The determination of a PE is also relevant for the purposes of other articles of a DTA, including withholding tax, taxation of capital gains, taxation of employment duties, other income and the non discrimination article.

The OECD Model and commentaries provides a comprehensive definition of a PE and provides a clear framework for the interpretation and application of PEs, including provisions on how to determine whether a PE exists, how to allocate taxing rights between countries and how profits should be attributed to it. In addition, it is widely accepted by countries which helps to reduce international juridical double taxation

The OECD commentary to Article 5 discusses the three elements of a PE in Article 5(1) as the following:

- *"the existence of a "place of business", ie a facility such as premises or, in certain instances, machinery or equipment;*
- *this place of business must be "fixed", i.e., it must be established at a distinct place with a certain degree of permanence; and*
- *the carrying on of the business of the enterprise through this fixed place of business".*

While Australia's legislation definition in subsection 6(1) ITAA 1936 does not refer to a fixed place, but rather just a place, and does not include references to what would be considered a fixed place like the OECD Model does, the tax rulings specifically reference a fixed place in paragraph 19-21 of the TR 2002/5 and include examples such as factory, workshop, mine, oilwell, office or agricultural or pastoral property in paragraph 21.

The commentary to Article 5 in the Model also provides useful examples of what does and does not constitute a PE, including:

- a meeting in customer's offices would not create a PE (paragraph 14), while staff of a parent company working in a subsidiary's offices may create a PE (paragraph 15);
- deliveries to a loading dock would not constitute a PE (paragraph 16);

- the presence of a painter working in the client office building may constitute a PE (paragraph 17), however where a painter works successively under a series of unrelated contracts for a number of unrelated clients in a large office buildings, it may not constitute a PE (paragraph 24);
- paving a road could create a PE (paragraph 20);
- a large mine may be a PE even though business activities may move from one location to another (paragraph 23);
- a ship that navigates in international water may not create a PE (paragraph 26); and
- a consultant trainer working in different branches may not create a PE, but if in different offices within the same branch a PE could be created (paragraph 25).

## 4. Practical considerations

### 4.1 What is a ‘Fixed Place of Business’?

While the Australian domestic law definition of PE does not directly include a reference to “a fixed place of business”, the Commissioner of Taxation’s interpretation of subsection 6(1) ITAA 1936 is published in TR 2002/5.

The Commissioner “*considers the phrase ‘a place at or through which [a] person carries on any business’ in the subsection 6(1) definition of PE has as its essence the concept of permanence*”<sup>7</sup>. In this concept of permanence, the Commissioner suggests an approach that considers both geographic and temporal permanence.

#### 4.1.1 Geographic Permanence

“Geographic Permanence” is defined in paragraph 29 in Taxation Ruling TR 2002/5 as follows:

*29. A place at or through which a person carries on any business in the context of the definition of PE in subsection 6(1) must be geographically permanent. Any area, viewed commercially and as a whole, may, in relation to the business concerned, be a place. Examples include business premises such as a factory, office, farm, mine or market. Thus a market is a place (and a place at or through which a trader carries on business) where that trader operates a stall regularly in that market. This is the case even if the stall is set up at different locations within the market at different times. It is the market which is, in relation to the trader, the distinct or discrete commercial area and it is therefore a place (and a place at or through which the trader carries on their business) within the definition of PE in subsection 6(1).*

In this concept of geographic permanence, the Commissioner stresses the importance of the place “*viewed commercially and as a whole, may, in relation to the business concerned*” and provides examples with reference to “*include business premises such as a factory, office...*”.

Paragraph 21 of the Model Commentary on Article 5 relevantly states that:

*“According to the definition, the place of business has to be a “fixed” one. Thus in the normal way there has to be a link between the place of business and a specific geographical point...”*

However, paragraph 22 also acknowledges that an enterprise may have a single place of business where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business. This principle is illustrated by the OECD in the following examples:

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<sup>7</sup> TR 2002/5, paragraph 25

“23.

- *A mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business.*

- *Similarly, an “office hotel” in which a consulting firm regularly rents different offices may be considered to be a single place of business of that firm since, in that case, the building constitutes a whole geographically and the hotel is a single place of business for the consulting firm.*

- *For the same reason, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand represents a single place of business for that trader.*

25. *Conversely, an area where activities are carried on as part of a single project which constitutes a coherent commercial whole may lack the necessary geographic coherence to be considered as a single place of business. For example, where a consultant works at different branches in separate locations pursuant to a single project for training the employees of a bank, each branch should be considered separately. However if the consultant moves from one office to another within the same branch location, he should be considered to remain in the same place of business. The single branch location possesses geographical coherence which is absent where the consultant moves between branches in different locations”.*

Based on the above examples it is clear that geographical permanence needs to be judged on a case by case basis.

#### **4.1.2 Temporal Permanence**

“Temporal Permanence” is defined in Taxation Ruling TR 2002/5 as follows:

*“30. The second criteria for a place at or through which a person carries on any business to exist for the purposes of the definition of PE in subsection 6(1) is temporal permanence, ie the business presence must not be of a purely temporary nature. In other words, the business must operate at that place for a period of time. Again, this has to be judged in the context of the particular business and is a question of fact and degree.”*

This is consistent with the Model Commentary on the PE Article 5 at paragraph 28:

*“28. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time...”*

As mentioned in section 3.3.2, the Commissioner of Taxation considers six months or more at a place to be temporarily permanent, and this six month threshold is repeated in the OECD Article 5 commentary at paragraph 29. However, the length of time that an activity must be carried on to create a PE will vary depending on the activity and the country a MNE group is operating in. Some examples, taken from the OECD commentary, include:

- A building site or construction or installation project, including the construction of buildings, roads, bridges or canals, the renovation of buildings, roads, bridges or canals, the laying of pipe-lines and excavating, and dredging, and the installation of a construction project or a new equipment, will create a PE only if it lasts more than 12 months; however, if an office or workshop is utilised for various construction projects, it will be regarded as a PE even if none of the projects lasts more than 12 months (paragraph 49-50)<sup>8</sup>.
- A subcontractor can create a PE at the site if his activities there last more than twelve months (paragraph 54)
- In the event of recurring activities, a PE can still exist regardless of the fact that any continuous presence lasts less than six months, as the duration of each period in which the place is used and the number of times that place is used must be taken into account (paragraph 29)
- where activities constituted a business that was carried on exclusively in that country, the business may have short duration due to its nature but since it is wholly carried on in that country, it could still be a PE even when it exists only for a very short period of time. (paragraph 30)
- where a particular place of business is used for only very short periods of time but such usage takes place regularly over long periods of time, it could still be considered as a PE (paragraph 32)
- 12 months test is used to determine if the enterprise carried on through a partnership will be regarded as a PE where a partnership is fiscally transparent (paragraph 56)

While the UN's Model largely follows the OECD, the UN Model reduces the temporal permanence test from 12 to 6 months<sup>9</sup>.

Article 14 of the MLI also has introduced an anti-contract splitting provision to ensure consulting services of 30 days or more that are supervisory or consultancy services in connection with that same business site shall be counted towards the total time period in determining whether there is a PE.

The imposed working from home and border restrictions from the COVID-19 pandemic caused concerns from MNE groups that these thresholds could intentionally be triggered. As a result, the OECD guidance *'Updated guidance on tax treaties and the impact of the COVID-19 pandemic'* (21 January 2021) outlines:

*"10. As explained below, the exceptional and temporary change of the location where employees exercise their employment because of the COVID-19 pandemic, such as working from home, should not create new PEs for the employer. Similarly, the temporary conclusion of contracts in the home of employees or agents because of the COVID-19 pandemic should not create PEs for the businesses. Finally, a construction site PE would not be regarded as ceasing to exist when work is temporarily interrupted. But jurisdictions may consider "stopping the clock" for determining whether the PE threshold has been satisfied during certain periods where operations are suspended as a public health measure to prevent the spread of the COVID-19 virus."*

While this provides relief to MNE groups, *"this revisited guidance applies only to situations arising during the COVID-19 pandemic while relevant public health measures to restrict the spread of COVID-19 are still in effect. It is temporary in nature and seeks to address the exceptional*

<sup>8</sup> Australia still considers that any building site or construction or installation project which lasts more than six months should be regarded as a permanent establishment (paragraph 201).

<sup>9</sup> *UN Model Double Taxation Convention between Developed and Developing Countries* (2017) Article 5, paragraph 3

*circumstances of the COVID-19 pandemic only. it can only be relied upon while the public health measures were in place*".<sup>10</sup> As discussed in section 3.3.2, the Commissioner of Taxation also outlines that while the six month threshold is considered temporal permanence, there would be extraordinary circumstances, such as the COVID-19 pandemic, that the six month rule would not create a PE for MNEs.

#### 4.1.3 Would a Home Office Qualify as a Fixed Place of Business?

Australia's domestic law does not directly address whether a home office is considered to be a fixed place of business. A home office is not mentioned in section 6(1) ITAA 1936, and TR 2002/5's listed examples of what could be considered a 'place' does not include home office. However, a 2019 ATO private binding ruling<sup>11</sup> may offer some insights on the Commissioner's view in considering whether the home office could constitute a PE. In this private ruling, the Commissioner considers the project site, the Head Contractor's office and the employee's home office to be the "fixed places of business for the Foreign Entity" with the reasons as below:

*"... the home office was used on a continuous basis for carrying on business activities for the Foreign Entity. It was clear from the facts and circumstances that the Foreign Entity was expecting that work to be performed at the home office of Y in Australia. .... home office of Y thus constitutes a place of business for the Foreign Entity while being used by the Foreign Entity employees and while used under the subcontracting arrangements."*

...

*"In this case, the fact that the services being performed under the contract are being undertaken at different fixed places in Australia does not affect the requirement for each place of business to be fixed."*

As DTA's also do not include clarification of whether a home office is a fixed place, the Model's commentary can provide guidance, as discussed in section 3.4.1.

The existence of a "place of business" could suggest on face value that the home offices would be excluded from meeting the PE definition. However the commentary to Article 5(1) clarifies that a place of business would include a home office:

*"10. The term "place of business" covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise..."*

*11. As noted above, the mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is therefore required."*

<sup>10</sup> Paragraph 5

<sup>11</sup> ATO Private Ruling (Authorisation Number: 1051570683369), permanent establishment, August 2019

*18. Even though part of the business of an enterprise may be carried on at a location such as an individual's home office, that should not lead to the automatic conclusion that that location is at the disposal of that enterprise simply because that location is used by an individual (e.g. an employee) who works for the enterprise. Whether or not a home office constitutes a location at the disposal of the enterprise will depend on the facts and circumstances of each case. In many cases, the carrying on of business activities at the home of an individual (e.g. employee 16) will be so intermittent or incidental that the home will not be considered to be a location at the disposal of the enterprise (see paragraph 12 above). Where, however, a home office is used on a continuous basis for carrying on business activities for an enterprise and it is clear from the facts and circumstances that the enterprise has required the individual to use that location to carry on the enterprise's business (e.g. by not providing an office to an employee in circumstances where the nature of the employment clearly requires an office), the home office may be considered to be at the disposal of the enterprise".*

It is clear from the above commentary that the home office of the Australian employee/contractor could satisfy the three limbs of the PE definition as referred to in Section 3.4.1, depending on the following:

- whether the home office is used on a continuous basis for carrying on business activities in Australia;
- whether the entity provides the Australia-based employees/contractors an office to work from, and thereby requiring these individuals to use their home offices to conduct their respective roles;
- whether there is alternative to work from an office, even if such an office was made available; and
- whether the role is required to be performed in Australia.

This is consistent with the example listed in the paragraph 19 of the Model Commentary:

*19. A clear example is that of a non-resident consultant who is present for an extended period in a given State where she carries on most of the business activities of her own consulting enterprise from an office set up in her home in that State; in that case, that home office constitutes a location at the disposal of the enterprise. Where, however, a cross-frontier worker performs most of his work from his home situated in one State rather than from the office made available to him in the other State, one should not consider that the home is at the disposal of the enterprise because the enterprise did not require that the home be used for its business activities. It should be noted, however, that since the vast majority of employees reside in a State where their employer has at its disposal one or more places of business to which these employees report, the question of whether or not a home office constitutes a location at the disposal of an enterprise will rarely be a practical issue. Also, the activities carried on at a home office will often be merely auxiliary and will therefore fall within the exception of paragraph 4.*

The example above clarifies that a consultant working from a home office for an extended period of time may trigger a PE, with an exception of where a cross-border worker chooses to work from home in one state rather than from the office available to him in the other state.

However, it is important to point out that the abovementioned "cross-frontier" example pertains to cross-border situations mainly applicable in Europe, where cross-frontier workers will travel short distances from home to work. In the context of Australia, it is uncommon and not practical to travel

from home to work across countries regularly. As a result, it would not be practicable for employers to expect employees based in Australia to travel to offices in other countries. Therefore, where employers do not provide an office in Australia, it would be the employer's expectation that the individual performs the work in his/her home. It is on this basis that conclusions reached for the cross-frontier worker should not be relied upon in the context of Australia.

In conclusion, provided that three limbs of the PE definition are met, the home offices may be considered to be at the disposal of the entity, regardless of the offices not being owned or rented by the entity. Accordingly, the home office may be a fixed place of business where the Australian business activities are carried on.

#### **4.1.4 Would a Shared Workspace Qualify as a Fixed Place of Business?**

Similar to the analysis of whether a home office would qualify as a fixed place of business in section 4.1.3, the shared workspaces such as WeWork may also trigger a PE for MNEs. The issue of whether shared workspaces would create a PE under Australian domestic law or the OECD Convention and its commentaries is not explicitly addressed. Therefore, the determination of whether a shared workspace constitutes a PE must be made on a case-by-case basis, taking into account the three main elements of a PE:

- the existence of a 'place of business',
- this place of business must be fixed; and
- the business of the enterprise is, wholly or partly, carried on through this fixed place of business

The use of a shared workspace will likely fulfil these three main elements and will satisfy the geographical permanence requirement (as mentioned in section 4.1.1, see "office hotel" example). The following OECD commentary to Article 5 re-affirms that a shared office space is likely to be considered a fixed place of business:

- The place does not need to be used exclusively for that purpose of carrying on a business of the enterprise (paragraph 10)
- It is immaterial if a place is owned or rented by the enterprise (paragraph 10)
- A place will be at the disposal of an enterprise even if the specific location belongs to another enterprise or that is used by a number of enterprises, provided that the enterprise performs its business activities at that location on a continuous basis during an extended period of time (paragraph 12)

## **4.2 If the Overseas Operations do not have Employees, is there still a PE Risk?**

While the interpretation of OECD Article 5(1) regarding the concept of "carrying on business" implies that the presence of employees is necessary to constitute carrying on business, the matter is not as straightforward. The below questions demonstrate that a non resident does not need to have employees located overseas to fulfil the concept of whether it is carrying on a business in another country.

### 4.2.1 What if I only have Contractors?

In the context of globalisation, MNEs often seek to hire talent from the local countries to expand their operations. To achieve this, some companies may look to engage individuals as contractors rather than employees, under the assumption that this approach is less likely to trigger a PE and thus poses a lower risk. However, this assumption may be misguided, as the determination of whether a PE exists is not contingent upon the classification of the individual as an employee or a contractor, but rather whether an enterprise is carrying on a business in the fixed place. Under the defined term of “enterprise” in the commentary to Article 3, the OECD suggest the that the term be interpreted according to domestic laws of the contracting states, however *“the term “enterprise applies to the carrying on of any business...[including] the performance of professional services or other activities of an independent character”<sup>12</sup>.*

The OECD Article 5 Commentary directly address the issue of contractors in the following paragraphs:

*“39. There are different ways in which an enterprise may carry on its business. In most cases, the business of an enterprise is carried on by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business of the enterprise (see paragraph 100 below).*

*40. An enterprise may also carry on its business through subcontractors, acting alone or together with employees of the enterprise. In that case, a permanent establishment will only exist for the enterprise if the other conditions of Article 5 are met (this, however, does not address the separate question of how much profit is attributable to such a permanent establishment). In the context of paragraph 1, the existence of a permanent establishment in these circumstances will require that these subcontractors perform the work of the enterprise at a fixed place of business that is at the disposal of the enterprise. Whether a fixed place of business where subcontractors perform work of an enterprise is at the disposal of that enterprise will be determined on the basis of the guidance in paragraph 12” (being, if the enterprise has a fixed place at its disposal)*

As a result, it is clear from the OECD commentary that even where an enterprise has only engaged contractors, it can still have a PE in a separate state if it carrying on activities in a fixed place over a period of time.

### 4.2.2 Employers of Record

In recent years, employers of record (‘EORs’) have emerged as a highly sought-after solution for businesses. However, it is critical to understand that operating the business by collaborating with EORs does not eliminate PE risk for that enterprise.

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<sup>12</sup> OECD Article 3 Commentary, paragraph 4.

According to the ATO private binding ruling<sup>13</sup>, “*expectation did not change upon commencement of the subcontracting arrangement with the Sub-subcontractor*”, with the following explanations:

*“Paragraph 40 of the OECD Commentary on Article 5 recognises that an enterprise may carry on its business through subcontractors, either acting alone or together with employees of the enterprise. It is irrelevant whether the enterprise uses employees to undertake work in Australia or subcontracts the work to others, either wholly or in part. That is, an enterprise cannot subcontract out of a permanent establishment in Australia where the other conditions of Article 5 are met.”*

Therefore, whereas the foreign entity is accountable for the services under the contract, regardless of whether the services are performed through the use of its own employees or through a subcontracting arrangements, the PE risk would still arise if the three limbs of the PE definition are satisfied.

It is also worthwhile to mention that Article 5 of OECD includes the following clause:

*“6. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the firstmentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of the paragraph with respect to any such enterprise.”*

Therefore, where the employees are working exclusively for the company, it would be difficult to argue that they are considered to be an independent agent under the exclusion clause in Article 5, paragraph 6 (which is discussed further below).

### 4.3 Dependent Agent

Under Article 5, paragraph 5, an enterprise shall be deemed to have a PE in another state where a person is acting on behalf of an enterprise in that state as a dependent agent. This person must habitually conclude contracts, or habitually play a principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. These contracts must

- a) [be] *“in the name of the enterprise, or*
- b) *for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or*
- c) *for the provision of services by that enterprise”.*

These dependent agents can be “*either individuals or companies and need not be residents of, nor have a place of business in, the State in which they act for the enterprise*”<sup>14</sup>.

Conversely, where a person is acting on behalf of an enterprise as an independent agent acting in the ordinary course of its business, the person will not create a PE for that enterprise (paragraph 6).

Article 5, paragraph 6 outlines that a person acting “*exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related*” shall not be considered to be an independent agent.

<sup>13</sup> ATO Private Ruling (Authorisation Number: 1051570683369), permanent establishment, August 2019

<sup>14</sup> OECD Model Article 5 commentary, paragraph 83

However, the commentary provides a number of other factors that should be considered in making the assessment whether a person is acting as a dependent or independent agent for an enterprise, including:

- the extent of obligations, such as whether the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control (paragraph 104);
- whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents (paragraph 104);
- the manner in which that work is carried out (paragraph 106);
- the number of principals represented by the agent (paragraph 109);
- whether the person takes an active part in the negotiation of important parts of contracts. (paragraph 89)

In order to be qualified as an "independent agent" and not be considered a "dependent agent", multinationals can no longer rely on the fact it has engaged a contractor and signed the contract in the country of residence of the enterprise. Rather, the agent must possess a capacity that generally involves a degree of discretion and autonomy in carrying out the multinational group's instructions.

As the independent agent exemption has historically been relied upon by multinational groups to avoid creating a PE in high tax jurisdictions, other issues specific to the exemption have been addressed by the OECD in their commentaries and the MLI. These include:

- whether the place the contract is signed is relevant to the creation or avoidance of a PE;
- how often and for how long the agent needs to negotiate contracts on behalf of the enterprise to be habitually and routinely concluding contracts;
- whether contracts concluded without active negotiation of the terms would be caught;
- the use of commissionaire arrangements and similar strategies<sup>15</sup>
- whether the role of the person is merely promoting and marketing (and therefore having a preparatory or auxiliary character).

## 4.4 Preparatory or Auxiliary Character

Under Article 5 paragraph 4 and 4.1 of the OECD Model, the carrying on of a business that only has a preparatory or auxiliary character will not create a PE. Paragraphs 58 –79 of the OECD commentary to Article 5 provides guidance to MNE groups so that they can consider if any of their overseas branches would fall into the preparatory and auxiliary exemption. Generally, *"a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise does not exercise a preparatory or auxiliary activity"* and therefore a preparatory or auxiliary activity will not form an essential and significant part.. of the enterprise as a whole"<sup>16</sup>. An activity has a preparatory character if it:

*60. ... is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant party of the activity of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the*

<sup>15</sup> Addressed by the OECD in Article 12 of the MLI, however Australia has chosen not to adopt Article 12.

<sup>16</sup> OECD Model Article 5 commentary, paragraph 59

*duration of that period being determined by the nature of the core activities of the enterprise...”*

Similarly, paragraph 60 of the OECD Article 5 commentary describes whether an activity has an auxiliary character:

*“An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole. It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character.*

Examples of what may be considered preparatory or auxiliary activities include:

- Training of employees at one place before they are sent to perform their duties in other places (paragraph 60)
- A fixed place of business that an enterprise maintains solely for the purpose of delivering spare parts for machinery sold to customers (paragraph 63)
- Maintaining an office for a 2 year period for the purpose of researching a local market and lobbying the government for changes that would allow a business to operate in the new market (paragraph 68)
- Collecting information such as statistics or risks on a particular market for an insurance enterprise, or information on possible investment opportunities in a particular market for an investment fund (paragraph 69)
- Advertising or supply of information without specifically altering this information for the purpose of the targeting specific customers or local market (paragraph 71)
- Servicing of a patent or know how contract (paragraph 71)

Examples of what may not be considered preparatory or auxiliary activities include:

- Despite Article 5, paragraph 4(a) and (b), the storage of goods in a large warehouse and delivery of those goods in a country, where a significant number of employees work in that warehouse will form an essential part of the business, and therefore not have an auxiliary character (paragraph 62)
- After sales activities such as delivery of spare parts to maintain or repair goods (paragraph 63).
- A consistent purchasing function in an overseas market (paragraph 68)
- Research activities where connected with manufacturing (paragraph 71)
- Supervisory and coordinating functions for a group, even if it only covers a certain area of the operations (paragraph 71)

It is important to note that in order for an enterprise to take advantage of the preparatory or auxiliary function, these activities referred to in Article 5, paragraph 7 must not be the core business activities of the enterprise as these activities may then satisfy the three core elements of the PE definition.

Article 5, paragraph 4 has been supplemented by an anti-fragmentation rule in Article 13 of the MLI to essentially provide that the preparatory/ auxiliary exemption will not apply where the business activities of the enterprise (or a closely related enterprise) are carried out, within the same jurisdiction and these “complementary functions form part of a cohesive business operation”. The main purpose

of this rule is to prevent an enterprise from fragmenting a cohesive business operation into several smaller activities to satisfy the preparatory/ auxiliary function and avoid creating a PE.

Finally, multinational groups should consider the intention of the preparatory and auxiliary exemption when assessing if its activities in a country satisfy Article 5, paragraph 4. The OECD's basis for providing such exemption is that it is recognised that these types of activities are so remote from actual realisation of profits of a business that it is difficult to allocate any profit to the activity. Accordingly, multinationals should consider the activities in a country as a whole, relative to the multinational group as a whole and whether there is a clear connection between those activities and the realisation of profits by the group.

## 4.5 Will having a Website Domain create a PE ?

On 22 December 2000 the OECD issued the following guidance on the application of the PE definition as it relates to e-commerce<sup>17</sup>:

*“6. This consensus includes the important views that a web site cannot, in itself, constitute a permanent establishment, that a web site hosting arrangement typically does not result in a permanent establishment for the enterprise that carries on business through that web site and that an ISP will not, except in very unusual circumstances, constitute a dependent agent of another enterprise so as to constitute a permanent establishment of that enterprise”*

*14. ..., in many cases, the issue of whether computer equipment at a given location constitutes a permanent establishment will depend on whether the functions performed through that equipment exceed the preparatory or auxiliary threshold, something that can only be decided on a case-by-case analysis. Some countries did not like that outcome and the uncertainty that may result from it. They suggested that, in the case of e-tailers, it would have been better to simply conclude that a server cannot, by itself, constitute a permanent establishment. In order to reach a consensus, however, most of these countries have accepted the view expressed above, noting that they will take into account the need to provide a clear and certain rule in their own appreciation of what are preparatory or auxiliary activities for an e-tailer.*

Following the 2000 publication, the OECD incorporated further guidance in the Commentaries<sup>18</sup>, and these draw the following conclusions:

- a website & the hosting arrangement will not give rise to a PE (paragraph 123);
- generally the Internet Service Provider ('ISP') will not create an agency PE relationship (paragraph 124;
- the place a server is located can create a PE if an enterprise carrying on a business through a website, has a server at its disposal and operates the server; (paragraph 123)

<sup>17</sup> OECD Clarification on the Application of the Permanent Establishment definition in e-commerce: Changes to the Commentary on The Model Tax Convention on Article 5, December 2000

<sup>18</sup> OECD Model Article 5 commentary, paragraphs 122-131

- the sales of products into Australia through a website will not create a PE on this basis alone (paragraph 130).

On the above basis, the mere existence of a website and website hosting arrangement does not pose a PE risk. However, if a server is situated in a country that performs more than preparatory or auxiliary functions, it may be deemed to constitute a PE. It is crucial to examine this matter on a case-by-case basis as certain criteria must still be fulfilled to qualify as a PE, including:

- The level of the activities performed by the enterprise;
- The permanence of the server;
- Whether the server is fixed; and
- Whether the server is at the disposal of the enterprise.

Therefore, it is imperative to thoroughly evaluate the circumstances of each case to ascertain whether a server located in another state can create a PE.

## 5. Country Specific Issues

Listed below are a number of countries that have taken an alternate position to the OECD Model and its commentaries on what constitutes a PE:<sup>19</sup>

- In the UK, the HMRC takes the view that a server either alone or together with a website does not constitute a PE of a business that is conducting e-commerce through a web site on the server. *"We take the view regardless of whether the server is owned, rented or otherwise at the disposal of the business"*.<sup>20</sup>

- Chile, Greece, Mexico, Portugal and Turkey also do not agree with the OECD's commentary on e-commerce.<sup>21</sup>

- Canada does not ordinarily consider a home office as a 'fixed place of business'.<sup>22</sup>

- Germany takes the view that business activities limited to on-site planning and supervision over a construction project can only constitute a PE if they met the requirements specified in paragraph 1 of Article 5, that being a place of management, branch, office, factory, workshop, mine, oil or gas well.<sup>23</sup>

- *"Germany takes the view that in order to permit the assumption of a fixed place of business, the necessary degree of permanency requires a certain minimum period of presence during the year concerned, irrespective of the recurrent or other nature of an activity. Accordingly, Germany does not agree with the criterion of economic nexus, to justify an exception from the requirements of qualifying presence and duration"*.<sup>24</sup>

- Like a number of other countries, Greece will recognise a PE if the enterprise carries on planning, supervisory or consultancy services in connection with a building site or construction or installation project if it lasts more than 6 months (as opposed to 12), if scientific equipment or machinery is used in Greece for more than 3 months in the exploration or extraction of natural resources or if carrying out more than one separate project, each one lasting less than six months, in the same year.<sup>25</sup>

- Estonia and Mexico reserve the right to tax individuals performing professional services or other activities, even if they are of an independent character, if they are present in the country for more than 183 days in any 12 month period.<sup>26</sup>

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<sup>19</sup> This list is largely based on the observations and reservations noted in the OECD Model and therefore, advice should be sought for specific circumstances.

<sup>20</sup> <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm264700>

<sup>21</sup> OECD Model Article 5 commentary paragraph 177

<sup>22</sup> In accordance with Canada vs Knights of Columbus, May 2008, Tax Court, Case No. 2008TCC307

<sup>23</sup> OECD Model Article 5 commentary, paragraph 172

<sup>24</sup> OECD Model, Article 5 commentary, paragraph 179

<sup>25</sup> OECD Model Article 5 commentary, paragraph 192

<sup>26</sup> OECD Model Article 5 commentary, paragraph 194, however Turkey and Latvia are also similar (paragraphs 196 and 197)

## 6. Implications of having a PE

### 6.1 How to Calculate the Profit Attributable to a PE

Article 7 of the OECD Model outlines how the business profits should be calculated for multinational groups including the distribution of taxing rights across various jurisdictions it operates in. According to paragraph 1 of this article, *“profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.”* On this basis, the business profits of a MNE are subject to taxation solely in the country of its residence, unless there is a PE.

The application of Article 7 to calculate the business profits attributable to a PE, can be approached in two different ways:

1. Functionally separate entity ('FSE') approach
2. Relevant business activity ('RBA') approach

#### 6.1.1 Functionally Separate Entity approach

The FSE approach suggests a PE should be treated as a separate entity from the rest of the enterprise and therefore its profits be determined accordingly:

*“the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise”<sup>27</sup>*

As a result, the profits should be calculated as if it were a “separate and distinct” enterprise engaged in the same or similar activities under the same or similar conditions, determined by applying the arm’s length principle.

Accordingly, the OECD Model Article 7(2) involves recognising internal transactions between the enterprise and the PE for the purposes of determining the profits attributable to the PE. This creates notional income and expenses, as well as notional debt and equity.

Before 2010, the OECD Model noted that two broad interpretations of Article 7 (1) were widely used by OECD members, being the FSE approach and RBA approach. From the 2010 Model, the Article 7 on Business Profits and its related commentary were substantially revised, clarifying that FSE approach is the only recommended approach when attributing profits to a PE.

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<sup>27</sup> OECD Model Article 7, paragraph 2

### 6.1.2 Relevant Business Activity approach

Alternatively, the RBA approach suggests the profits attributable to a PE should be determined on the economic activity that takes place in the country where the PE is located. Accordingly, the attribution of profits to a PE should reflect the resources and activities at the relevant place.<sup>28</sup>

ATO ruling TR 2001/11 explicitly states that Australia has adopted the RBA approach on the basis that, *“in substance, the resources and activities at the relevant place are the source of the profit”*<sup>29</sup>.

Paragraph 5.1 further clarifies 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.”* However, it is also worth noting that in 2001 when the aforementioned ruling was issued, the Model and Commentary on Article 7 had not been updated yet and RBA was the preferred approach in the Model.

The possible explanations that Australia has not adopted the FSE approach are listed as followings:

- The exercise of the FSE could result in unintended tax outcomes, such as the potential for the creation of taxable gains or losses on the internal disposal of assets between a head office and the PE upon a reallocation or change in usage.
- FSE could give rise to an inappropriate mark-up for services provided between the head office and the PE.
- Application of FSE to certain structures such as the single employee working in another jurisdiction may be inappropriate and impractical.
- FSE approach may be applicable to PEs with active businesses but not necessarily to the deemed PE.
- The possible impact of the FSE approach on an entity established under a trust.
- Australia has already established its transfer pricing laws and implementing the new approach may require the modifications to these laws to accommodate the change.

In 2013, division 815 ITAA 1997 was introduced and the government reinforced that RBA approach is the preferred basis to determine profits attributable to a PE. Division 815-C of the ITAA 1997 modifies Australian transfer pricing rules specifically for PEs. Within this division, section 815-225 states that the arm's length profit of a PE is determined by the allocations of the entity's actual income and expenditure between itself and the PE, in such a way that the profits attributed to the PE equal the profits that the PE might be expected to make if:

- *‘the PE was a distinct and separate entity; and*
- *the activities and circumstances of the PE, including the functions performed, assets used and risks borne by the PE, were those of that separate entity; and*

<sup>28</sup> TR 2001/11, paragraph 3.16

<sup>29</sup> TR 2001/11, paragraph 3.16

- *the conditions that operated between that separate entity and the entity of which it is a PE were the arms length conditions”.*

As Australia’s chosen approach, the following can and cannot be allocated in calculating the profits of a PE either in Australia or that of an Australian enterprise in accordance with TR 2001/11:

- External interest costs – only of from a third party lender or directly traceable to lender (paragraph 3.43)
- Internal interest costs – if internally generated, no notional interest charge can be recognised (paragraph 3.43)
- Head office costs – can only allocate services at cost (paragraph 5.36)
- Contribution to R&D spend: cannot charge royalty on internal transaction and can only allocate costs (paragraphs 3.61 - 3.63)
- Third party costs: No mark up unless same service provided to third parties or costs represent significant proportion of total costs of that enterprise (paragraphs 3.38, 5.35)
- Trading stock: Only appropriate to allocate stock purchased and not overheads – (paragraph 3.37)
- Depreciation on capital equipment: If transferred to PE, can claim depreciation under division 40 ITAA 997 from time plant is used to produce assessable income (paragraphs 5.17, 5.23)
- No shareholder costs (paragraph 5.31)

## **6.2 Implications for MNE Groups having a PE in Australia**

### **6.2.1 Australian compliance requirements for employers**

If a foreign enterprise is found to have an Australian PE, there are a number of initial and ongoing compliance requirements to be satisfied. These include:

- **Pay-As-You-Go (‘PAYG’) Withholding and Single Touch Payroll (‘STP’)**

Under the PAYG withholding regime in Australia, a payer must withhold amounts from wages and allowances paid to individuals who are considered to be employees under common law principles. However, this Australian employer tax obligation will exist whether or not the entity has a PE in Australia. The withholding and remittance of PAYG is not optional and is a mandatory employer obligation. STP is mandatory reporting for employers with an Australian Business Number (‘ABN’) and reporting can be completed through Australian payroll service providers or registered tax or BAS agents. Other types of reporting for payroll and payments made to individuals will depend on whether they have already been reported through STP.

- **Fringe Benefits Tax (‘FBT’)**

FBT will be payable on non-cash benefits provided to the employees unless an exemption or concession applies. Should FBT apply, the entity will be required to lodge an FBT return to report and pay the required FBT for the period 1 April to 31 March. FBT is calculated at the rate of 47% of the grossed-up value of the benefit provided.

- **Superannuation Guarantee ('SG')**

Under the *Superannuation Guarantee (Administration) Act 1992*, employers are required to make SG contributions to a complying Australian superannuation fund of the employee's choice for the benefit of their eligible "employees" in accordance with minimum prescribed levels (currently 10.5% of the ordinary time earnings and is planned to progressively increase to 12% by 2025).

Technically, where an individual "employee" (whether tax resident or not) performs work in Australia, the employer will have an obligation to make SG contributions in respect of the relevant payments unless the employee is eligible for an exemption, such as the '*SG opt out for high income earners with multiple employers*' certificate.

- **Payroll Tax**

Payroll tax is a self-assessed state and territory tax assessed monthly on wages paid or payable by an employer to its employees. Broadly, if an employee performs services in an Australian state for an entire month, employers may be liable to pay the tax as a percentage of those wages if aggregated annual Australian wages are above a certain threshold. The percentage of tax payable ranges between 0.02%– 6.85% and the thresholds ranges between \$700K - \$2 million, depending on the state.

- **Workers Compensation**

Employers in each state/ territory are required to take out workers compensation insurance through the state designated fund(s) to cover themselves and their employees. The amount of the premium payable is calculated with reference to the wages paid to the employees, the nature of the employer's business and the employment activities of the employee (ie it is based on a risk assessment of the employment).

## **6.2.2 Penalties**

Each Australian employer tax obligation has its own regime and rules dealing with penalties for non-compliance. Failure to comply with these various Australian employer tax obligations may result in fines and penalties for the employer and the loss of income tax deductions.

Company directors are legally responsible for their company to meet various tax obligations and failure to meet these obligations may result in the director being held personally liable for penalties equal to unpaid liabilities and in some instances criminal penalties.

Significant global entities ('SGEs') are subject to increased penalties. A SGE is defined as:

- a global parent entity whose annual global income is \$1 billion or more; or
- a member of a group of entities consolidated for accounting purposes where the global parent entity has an annual global income of \$1 billion or more; or
- a member of a notional listed company group and one of the other group members is a global parent entity with an annual global income of \$1 billion or more.

Of relevance, the Failure to Lodge ('FTL') on time penalties may be applied if the PE is required to lodge an "Approved Form" with the ATO by a particular day but does not. The FTL penalty for an entity considered to be a SGE is 500 times the penalty that applies to certain other taxpayers. FTL penalties for a SGE range from \$137.5K for up to 28 days late to \$687.5K for more than 112 days late.

## 6.3 Implications for Australian entities having a PE Overseas

When an Australian business has a PE in a foreign country, it must comply with both reporting and tax obligations in the host country under its relevant regimes. However, this creates Australian tax implications that need to be considered.

### 6.3.1 Branch Profits Exemptions

Generally, Australia entities are subject to tax on their worldwide income. However, under section 23AH(2) ITAA 1936, "*foreign income derived by a company, at a time when the company is a resident, in carrying on a business at or through a PE of the company in a listed country or unlisted country is not assessable income, and is not exempt income, of the company.*"<sup>30</sup> This means that when an Australian company derives active income from an active branch located outside of Australia, the income will be exempt from Australian tax. It is important to note that section 23AH will not apply should Australia's foreign hybrid mismatch rules apply.

### 6.3.2 Thin Capitalisation Rules

On 16 March 2023, the Government released the draft legislation which if passed will mark significant changes to Australia's thin capitalisation regime. The proposed changes would apply from income years starting on or after 1 July 2023 and would limit debt deductions to Australian entities for tax purposes up to 30% of its tax EBITDA.

The proposed legislation will also disallow interest deductions incurred in respect of foreign equity distributions that are non-assessable non-exempt ('NANE') income under subdivision 768-A ITAA 1997.

### 6.3.3 Transfer pricing models

Transfer pricing issues can often arise when a multinational group establishes a PE in a foreign country, and a closer examination is required to ensure that the transfer pricing policies adopted by MNEs are consistent with the arm's length principle.

The arm's length principle must be applied to determine the appropriate amount and basis to recognise intragroup transactions, such as remuneration for the employees of the PE, and the sales and purchase of goods and services provided by the PE. Furthermore, the allocation of profits between the different entities within a multinational group should also be examined in accordance with the appropriate transfer pricing methodology. This methodology should be based on a thorough

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<sup>30</sup> Section 23 AH of the Income Tax Assessment Act 1936

analysis of the functions performed, risks assumed, and assets employed by each entity, as well as on the market conditions and economic circumstances in which they operate. Section 5.1.2 *Relevant business approach* further explains Australia's transfer pricing rules specifically for PEs.