BRANCH PROFITS EXEMPTION AND TREATIES

AUSTRALIAN TAX LAW DESIGN

Since 2004 it has been a design feature that active foreign business (and other non-tainted activities) can be carried out either by a non-resident subsidiary, or by a foreign branch of an Australian company, with Australian tax on the profits deferred pending their release from the corporate group. The 2004 amendments were designed to ensure consistency of outcome in the choice between a subsidiary and branch.

SUBSIDIARY v BRANCH

Foreign subsidiaries have usually been preferred to branches, to ensure a clear delineation of the foreign activities to the domestic activities carried on by the Australian company[1].

In relation to the tax deferral issue, whilst a non-resident subsidiary still needs to carry on business through a permanent establishment ("PE") in the country of residence[2], the fact of incorporation in the country of residence and the presence of central management and control of the non-resident company in the country of incorporation, as well as the location of a registered office there, goes a long way to ensuring the existence of the PE.

The decision in *Unisys Corporation v FC of T* [2002] NSWSC 1115 was in relation to whether an Australian limited partnership carried on business in the US through a PE there[3], but is guidance that forming a branch of an Australian company overseas, probably needs more attention to detail than the formation of a subsidiary.

LABUAN SUBSIDIARY OR BRANCH

The 80% of Malaysia's DTAs cover Labuan entities. Where they do, or where Australia does not have a DTA with a source country, whereas Malaysia does[4], for the reasons outlined above, usually a Labuan subsidiary will be formed to do business with the source countries[5].

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1 refer TR 2001/11

2 In order to meet the active income test.

3 It should be borne in mind that the case involved a scheme to artificially avoid Australian withholding tax on royalties.

4 Bahrain, Bangladesh, Brunei, Croatia, Egypt, Iran, Jordan, Kazakhstan, Kyrgyztan, Kuwait, Lebanon, Mauritius, Mongolia, Morocco, Myanmar, Namibia, Pakistan, Qatar, Saudi Arabia, Seychelles, Sudan, Syria, Turkey, Turkmenistan, United Arab Emirates, Uzbekistan.

5 Where the source country has a DTA with Malaysia which does not exclude Labuan entitles i.e. about 50 DTAs, it is usually preferable to use a Labuan company to ensure clear segregation of its activities from its owners, which is always easier than with a branch operation. Further, a branch operation does not allow hybrid ownership structures which may allow principals to become non-resident before large capital gains are made.

ALTERNATIVE TO MALAY SATAY

Where Malaysia's treaty partners have refused to accept Labuan entities as entitled to the benefits of their DTA[6], the general response has been to use a "Malay Satay" structure: a Labuan company owns a Malaysian Sdn Bhd, which earns the foreign income. A Sdn Bhd is not assessable on its foreign source income (except from banking, insurance, shipping or air transport), even if remitted into Malaysia[7], but the question of source of income, is like in Hong Kong and Singapore, difficult, and to get this wrong is to incur 26% Malaysian tax (see below).

In the case of the Australian investors who might have used a "Malay Satay" structure, there is another alternative.

That is, due to the branch profits exemption under s23AH as it has applied since 2004, for the approximate cost of buying a Labuan subsidiary, it is possible to have an Australian company recognized as a "foreign Labuan company"[8], which will then get the benefits of Australia's DTAs with source countries, even though the branch profits are not subject to Australian tax while kept in the Australian company. This also avoids the cost a acquiring a Sdn Bhd as subsidiary of a Labuan company.

This can be used for trading profits, from goods or services, for any source country which has a DTA with Australia, but has no DTA with Malaysia[9], or has a DTA with Malaysia but excludes Labuan entities. A good example is the US, which has a DTA with Australia but not Malaysia, (nor Singapore or Hong Kong). There is also a specific example below, relating to royalties, which is more complicated.

PROPOSAL FOR SALES & SERVICES INCOME

Under the US domestic law, a non-resident trading company will only have a liability to US income tax on its trading if it carries on a "trade or business" which is "effectively connected" with the US. The selling of goods into the US on a "considerable, continuous and regular" basis[10] would certainly be a "trade or business" but the question is whether the level of activity in the US makes it a US trade or business[11] (*Handfield v Commissioner* 23 T.C. 633 (Tax Ct. 1955). The solicitation of orders, the inspection of merchandise, and the purchase and sale of

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6 Australia, UK, Japan, Netherlands, Sweden, Norway, Finland, Indonesia, South Korea, Luxembourg and Germany.

7 ¶ 28 Sch 6 Income Tax Act 1967

8 Under Part VIII of the Labuan Companies Act 1990, rather than a re-incorporated company under s16.

9 US, Mexico, Argentina, Kiribati, Slovak Republic.

10 *Lewellyn v Pittsburgh, B&L.E.R. Co* 222 F. 177, 185-6 (3rd Cir. 1915)

11 Also see Rev. Rul. 73-158, 1973-1 Cum. Bull 337

merchandise in the US by Argentine resident individuals, was enough for the "trade or business" to be "effectively connected" with the US in *US v Balanovski* 236 F.2d 298 (2d Cir. 1956). If the "trade or business" is effected even through an independent agent in the US, this may still be "effectively connected" with the US: *Lewenhaupt v Commissioner* 20 T.C. 151 (Tax Ct. 1953). This is a lower threshold than a treaty PE in the US, where a dependent agent still has to have and exercise an authority to contract on a habitual basis to constitute a treaty PE[12].

Where Australian resident investors expect to derive US source trading income in circumstances where the presence in the US is less than that of a treaty PE, they have limited treaty choice as the US does not have DTAs with low tax countries, and has detailed Limitation of Benefits ("LOB") articles which severely restricts "treaty shopping" in any event.

The following assumes the Australian company referred to is owned by Australian residents, so there is no problem with the LOB article in the US / Australia DTA (Art 16).

The DTA with Australia eliminates the 30% corporate tax on "US trade or business" income where the Australian resident company does not have a PE in the US (Art 7).

The US model DTA and the OECD model DTA apply reductions in rates of tax based on the *residence* of the recipient, even where, for whatever reason, the recipient isn't taxable on the US (or OECD) sourced income.

Branch Profits Exemption

Where countries provide a branch profits exemption from their company tax, such as Australia does via s23AH, and the US source income is "effectively connected" with that foreign branch, the US source income is not taxed to the Australian company, but because it is an Australian resident company, it is none the less entitled to the reductions in US tax or withholding rates.

The OECD model commentary (¶ 53 on Art 24), and the US Treasury recognise this problem, and suggest it can be dealt with expressly in treaties where it is considered a problem, on a country by country basis. Recent US treaties with Belgium and Hungary expressly deal with this so-called "triangular" tax issue[13].

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12 However, trading in securities or commodities for the foreign taxpayer's own account even though a dependent agent and even if the taxpayer has an office in the US is excluded from being a US trade or business, as long as the taxpayer is not a "dealer". Even a "dealer" will not have a trade of business in the US as long as the taxpayer trades through an independent agent, as long as the taxpayer does not have an office in the US: s865(b)(2)(A)(i) &(ii), & 864(b)(2)(C).

13 See material submitted by Joint Committee on Taxation for Senate Committee on Foreign Relations hearings into DTAs with Hungary on 17.07.07 and Belgium on 07.06.11. Historically the Swiss finance branch of a Dutch or Luxembourg company was well known for tax effective international treasury operations.

The 2001 Australia US DTA does not deal with it, and there is no suggestion that the treaty is going to be renegotiated any time soon.

However, if the branch of the Australian company is in a high tax country, what the US does not tax, will end up being paid in the branch country, and the branch country may or may not give a credit for the US tax.

Location of Branch

In our region, if the branch is in a low tax (territorial system) country (of which Singapore, Malaysia and Hong Kong readily spring to mind), deferral of Australian tax can last as long as the branch profits are kept in the Australian company.

A branch is a type of PE, usually constituted by an office. A PE is a fixed place of business through which the business of the enterprise is wholly or partly carried on: refer TR 2002/5.

But when are the trading profits “effectively connected” with a branch, and when are they entitled to branch profits exception?

Tainted Sales & Services Income

The second question first: Sales or services income will be excluded from the branch profits exemption in circumstances where, had they been derived by a CFC, the income would have been “tainted sales income” or “tainted services income”. To avoid being “tainted sales income”, it must be derived from purchases and sales from unrelated parties who are not Australian residents[14]. To avoid being “tainted services income”, the income must not be for services provided to an Australian resident[15]. The proposed re-write of the CFC provisions will liberalise these tests considerably[16].

When is the income “effectively connected” to the branch: This is less difficult, when the location of a tangible asset e.g. machinery or trading stock, is in the branch country. It is more difficult when trading stock is bought in one country e.g., and is sold to another e.g. the US, without having physically moved through the branch country.

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14 or the Australian PE of a non-resident: s447(1). Where goods are altered or developed by the CFC by the company’s directors or employees, they will not give rise to “tainted sales income”.

15 or the Australian PE of a non-resident: s448(1).

16 The CFC provisions are in the process of over 5 years re-examination. The latest version of the Exposure Draft still has significant flaws (e.g. the control test & “disconnected income” test), and is unlikely to proceed in that form. It was supposed to be effective from 1 July 2012. This is now likely to be 1 July 2013 at the earliest. The only realistic way to proceed at the moment, is to ensure compliance with the current law, as the future law is too uncertain. The government has always said that the “reform” package will be enacted “subject to budgetary constraints”. As the “reform” will cost the government revenue, there is still some possibility that the measures might be shelved. Indeed, the Treasury forward work program as at June 2012 reveals that no work is currently scheduled on the project.

When a CGT asset is moved to an offshore branch, it is deemed to be disposed of for market value, pro-rata the number of days it was used in Australia compared to the time it has been owned before leaving Australia[17].

Depreciable equipment is treated as being disposed of for market value[18], under Div 40, on the basis that when it moves to the branch, it is no longer being used to derive assessable income[19], but rather non-assessable non-exempt (NANE) income under s23AH.

In the case of intangibles, it is perhaps less obvious, but the better view would be where the IP is no longer being "used" to derive assessable income, because it is now being used to produce NANE income, in which case under Div 40, like depreciable equipment, there is a balancing charge[20].

Use by Branch

What is "used" by a branch? The better view is that it is used by the branch if the asset is exploited by the branch and not by the home office. If the purchases and sales of goods, or their development takes place in or from the branch country, and is paid from the branch's resources, and then is exploited by the branch management i.e. dependent agents, then this should meet the test. The provision of services by the branch must be effected by employees of the branch, but they are more likely to be effectively connected to the branch if they also resident in the branch country.

Singapore & Hong Kong

Obviously the branch country must be chosen which won't tax the trading income, or at least not at a high level. A practical problem with ordinary Malaysian income tax, and with Singapore and Hong Kong income tax, is it depends on the source of the income. For US purposes, the source of income from the sale of purchased inventory is where the title passes[21], not where the contract is entered into. So a purchase outside the US and its sale within the US is US source gross income[22], and a purchase within the US and its sale outside the US is foreign source gross income[23]. For US domestic purposes, Reg 1.861-4(b)(1) makes it clear that where a company

17 s855-35

18 s40-330(2)

19 s40-295(1)(b)

20 Depreciable assets in Div 40 include "intellectual property" (s40-30(2)(c)), which is defined in s995-1 to be patents, registered designs, and copyrights. Trademarks and dealings in know how (other than mining information) are dealt with under the CGT provisions.

21 Reg 1.861-7(c)

22 s861(a)(6)

23 s862(a)(6)

provides the services of its employee, it is where the employees perform the services that is relevant.

However, in Hong Kong, the IRD says in its 2009 version of the paper on source of income:

> “21. When Lord Bridge said in *Hang Seng Bank* that profits from buying and reselling of commodities were derived from the place where “the contracts of purchase and sale were effected”, he could not merely mean legally executed (as this would depend on formal legal rules of offer and acceptance). The Department agrees with the approach in *Magna* and will contemplate all the relevant operations carried out to earn the profits, including the solicitation of orders, negotiation, conclusion, trade financing, shipment and performance of the contracts.”

Even if HK has a DTA with the country of source, that treaty is not applicable as the HK branch is not a resident of HK (as it is a branch of an Australian resident company). As the law of source in HK is usually persuasive in Singapore and Malaysia, there is a risk of incurring (ordinary) Malaysian, Singapore or HK tax, if the branch is there, at 26%, 17% or 16.5% respectively.

Labuan Branch

What about a Labuan (Malaysia) branch? Provided a foreign company registers as such in Labuan, it is excluded from treatment under the Malaysian Income Tax Act 1967 (by s3B), and falls under the Labuan 3% of audited profits or RM20,000 tax[24]. The cost of registration is comparable to the cost of incorporation, but the certainty provided by registration is well worth it.

Australian Shelf Company

The best structure would be to start off with an Australian shelf company that does nothing much in Australia (other than hold directors meetings)[25], and starts to do things in Labuan on registration. To transfer all that an existing Australian company has, to the branch on registration might be practically more difficult, and may give rise to transfer pricing issues with respect to the reorganization: refer TR 2011/1. The shelf company could then open a bank account in Labuan, and from that resource, to develop the business from scratch, or to buy the business and then develop it in Labuan.

Transfer Pricing

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24 As it is then a “Labuan company” as defined by the Labuan Business Activities Act 1990.

25 It should lodge a tax return in Australia as soon as possible even though it might not have any tax to pay, so that it can obtain a tax residency certificate from the ATO, which it may need to get the benefit of Australia’s DTAs.

Para 21 of the OECD commentary (now ¶ 34 of the 2010 version) on model Article 7, says that no part of the branch profit needs to be allocated to the head office were the only thing that happens in head office are the holding of directors' meetings. The OECD commentary also makes it clear that the starting point for the allocation of profits to the PE will be commercially drawn accounts for the PE (¶ 12, now 15 of the 2010 version).

It should be noted that the pre 2010 version of the commentary on Art 7 was based on arm's length transactions, whereas the 2010 version is based on functional analysis. Australia has not yet expressed formal reservations on the change, but the Assistant Treasurer has referred that issue to the Board of Taxation on 24 May 2012. Under the 2010 version, it is clear that more functions should be performed by the branch itself, rather than the branch contracting for related parties to do the work for a fee.

Having sales or services provided to several countries through the Labuan branch will add to the substance of the arrangements[26].

The registration of the Australian company as a "foreign Labuan company" is a useful statement of intent to form a branch[27].

PROPOSAL FOR US ROYALTY INCOME

The DTA with Australia reduces the general 30% withholding rate on royalties to 5% (Art 12).

Tainted Income

The royalties will be excluded from the branch profits exemption in circumstances where, had they been derived by a CFC, the income would have been "tainted royalty income". To avoid being "tainted royalty income", it must be derived from unassociated parties, and the IP must either originate with the CFC, or if not, to have been altered or developed, so as to have been "significantly" enhanced in terms of its market value[28].

Use by Branch

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26 *Unisys Corporation v FC of T* [2002] NSWSC 1115 found that there was insufficient repetition of contractual activity for USI as the general partner of the UAL limited partnership, to constitute a PE in the US of UAL, as USI did not "habitually" enter into contracts on UAL's behalf (at ¶ 74). UAL only did business with one associated company. It did not seek business from anyone else.

27 and necessary to avoid treatment under the Malaysian Income Tax Act 1967.

28 The latest version of the Exposure Draft for CFC reform, still has significant flaws (e.g. the "disconnected income" test), but is unlikely to proceed in that form. Under the current proposal, the CFC needs to have a more real connection with the place of its residence, in order that "*prima facie* passive income" (such as royalties) can meet the active income test.

What is "used" by a branch? The better view is that it is used by the branch if the IP is exploited by the branch and not by the home office. If the development of the IP takes place in the branch country, and is paid from the branch's resources, and then is exploited by the branch management by being licensed by the branch management i.e. dependent agents, then this should meet the test.

Singapore & Hong Kong

For US domestic purposes, it is the place of the use of the IP which determines the source of the income[29]. So the use by a US customer of the IP in the US will be US source.

However, in Hong Kong, the IRD says in its 2009 version of the paper on source of income, that royalties can be taxed in HK if the rights were obtained in HK or were licensed in HK, even if the use by the customer is outside HK. *HK-TVB International Ltd v CIR* [1992] 2 AC 397 supports that interpretation. Even if HK has a DTA with the country of residence of the payer, which would have deemed the source to the country of residence of the payer, that treaty is not applicable as the HK branch is not a resident of HK (as it is a branch of an Australian resident company). As the law of source in HK is usually persuasive in Singapore and Malaysia, there is a risk of incurring (ordinary) Malaysian, Singapore or HK tax, if the branch is there, at 26%, 17% or 16.5% respectively.

Australian Shelf Company

The shelf company would have a bank account in Labuan, and from that resource, it would develop the IP from scratch, or to buy the IP and then develop it in Labuan. If the IP already exists in the Australian company that is forming the branch the internal transfer of the IP should be recognized for tax through the documentation (as the branch can't buy the IP from itself, even if it transfers funds to Australia for the transaction), and for tax, to recognize some Div 40 balancing charge.

Royalties Generally

The same plan will work for royalties from other countries, but the solution for the US is more significant as other countries don't usually charge such a high rate of withholding tax as the US rate of 30%.

Having several countries licensed through the Labuan branch will add to the substance of the arrangements. Indeed, for a particular item of IP, the conclusion will often be that all the licensing takes place through the branch, or through a subsidiary, and so identifying the largest likely royalty flows and the withholding rates that would apply to Malaysia or Australia, will probably determine whether a subsidiary or branch should be used.

DISCLAIMER

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29 s861(a)(4) IRC

This paper does not constitute advice. It should not be relied on as such. Persons wishing to explore these opportunities further should seek professional advice.

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