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Attribution of Profit to Permanent Establishments - Asia Overview

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Introduction

In July 2010 the OECD published its final Report on the Attribution of Profits to Permanent Establishments (Report). Taking more than ten years to complete, the Report provides a comprehensive analysis of the OECD's approach to the topic, and sets out what is now colloquially known as the 'AOA', or the authorised OECD approach to profit attribution.

As is now well known, the AOA hypothesises that the permanent establishment (PE) is a separate and distinct legal entity from its head office, as in the case of a parent / subsidiary relationship. Based on this hypothesis transfer pricing rules can then be applied to the PE through the performance of a functional analysis and application of prescribed transfer pricing methodologies.

Four years since the OECD published its Report, PwC has conducted a survey of the legislation covering the attribution of profit to PEs that is in force throughout the Asia Pacific region. The initial aim of this survey was to understand the impact of the OECD's Report on taxation rules in the region, as they apply to PEs.

As can be seen from the contents of this publication however, there remain significant differences in how profit will be attributed to PEs. While this is understandable in those jurisdictions that are not OECD members, the lack of consistency in rules among OECD member countries in the region is more surprising. For example, although 2014 tax reforms in Japan and Korea have introduced the AOA concept into local law, Australia has yet to do so.

Given the wide disparity in approach within the region therefore, PwC hopes that this publication will also serve as a useful starting point for multinationals that are either operating in branch form or that have other forms of PEs in Asia Pacific.

Notwithstanding the usefulness of this summary however, it will be important to monitor legislative reform in all countries going forward. The rules governing attribution of profits to PEs will continue to evolve in all jurisdictions and tax practitioners will need to keep abreast of developments. PwC will continue to serve as a contact point for information about such changes as they occur.

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Australia

Australia

1. What domestic law and transfer pricing-like guidance / rulings have your local tax authorities given on attribution of profits to PEs?

Australia's domestic transfer pricing provisions relevant to PEs are contained under:

- Division 13 of the Income Tax Assessment Act 1936
- Subdivision 815-A of the Income Tax Assessment Act 1997
- Subdivision 815-C of the Income Tax Assessment Act 1997

Division 13 Section 136AD applies to all taxpayers for income years commencing prior to 1 July 2004, and for dealings between an Australian entity and a foreign branch for income years commencing prior to 1 July 2013. For non-resident companies from countries with which Australia does not have a tax treaty, the ordinary rules of source of income apply. For non-resident companies located in countries with which Australia does have a treaty, the PE rules in the treaty override domestic law and govern the treatment of profits taxable in Australia. The rules in the treaty are consistent with Australia's domestic PE approach which allocates actual income and expenditure.

Subdivision 815-A applies to taxpayer dealings (apart from foreign branches of Australian entities) for income years commencing on or after 1 July 2004 to 30 June 2013. This Subdivision incorporates relevant guidance from the OECD (apart from the 2010 AOA) into domestic law and is applied to ensure consistency between Australia's tax treaties and domestic law. For non-resident companies from countries with which Australia does not have a treaty, the ordinary rules of source of income continue to apply.

The introduction of Subdivision 815- C for income years commencing post 1 July 2013 ensures that a single set of rules applies to both tax treaty and non-tax treaty cases. The intent of Subdivision 815-C is to align Australia's current approach to the attribution of profits to PEs, the Relevant Business Activity (RBA), that is incorporated into Australia's tax treaties.

Australia treaties and domestic law in 815-C currently do not align with the AOA with respect to the attribution of profits to PEs. Under the ATO's RBA approach, only actual third party income and expenses can be allocated between a head office and its PE.

To date, the main practical guidance issued by the Australian Taxation Office on PE attribution issues are Taxation Ruling TR 2001/11 and TR 2005/11. TR 2001/11 indicated that the Australian Tax Office (ATO) intended to issue a separate ruling, dealing with PE attribution issues that are of special importance to, or are particular to, multinational banks. However, to date this has been limited to issues related to inter-branch funds transfers (TR2005/11).

TR2005/11 provides for the recognition of 'internal loans' for the purpose of attributing actual income and expenses of a bank from third party funding transactions as an acknowledgement that it is practically difficult and in some instances impossible to apply the current RBA approach to profit attribution. This effectively adopts the OECD approach. In December 2013, the ATO provided a draft discussion paper indicating that it will recognise internally recorded derivatives only in cases where they directly relate to an identifiable external transaction with an unrelated third party (i.e., an external derivative) and the internal derivative allocates the derivative position to the jurisdiction that functionally manages the risk based on a functional analysis. This approach is limited to internal derivatives relating to interest rate and currency risk and specifically excludes credit risk, commodity price risk and equity price risk.

Furthermore, the guidance applies only to Australian resident financial institutions with foreign PE operations and does not extend to foreign bank branches.

With respect to foreign bank branches, the operation of Part IIIB of ITAA 1936 effectively allows an Australian branch of a foreign bank to be treated as a separate legal entity and not a PE. Accordingly, certain notional loan and derivative transactions between the branch and head office reflected in the accounting records of the branch are recognised as if they were between separate legal entities.

Where Part IIIB does not apply, the ATO's RBA should be followed in determining the attribution of profits to PEs.

2. If adopted, please detail how the AOA has been implemented in your jurisdiction (e.g., enabling legislation, changes to existing treaties).

The AOA has not been adopted in Australia. New legislation has recently been enacted in Australia aligning our current tax treaty RBA approach with our domestic law. In practice, Australia's PE rules may lead to inconsistent outcomes with those under the AOA.

3. What is the current treatment of the following notional transactions between a head office and its PE? Specifically:

- **Trading stock (e.g., inventory)**
- **Intangibles / royalties**
- **Interest**
- **Services**
- **Risk transfers**

Trading stock

TR 2001/11 authorises the 'trading stock solution' as an administrative practice for internal stock transfers (supply or acquisition of stock) on the proviso that the attributed outcomes are the best estimate of PE profits based on each entity's functions, assets and risks (i.e., effectively the separate entity approach).

Interest

Under Australia's RBA approach, notional dealings are not recognised between separate parts of the same legal entity. However, for multinational banks, the ATO has accepted (in TR 2005/11) that interest charges on internal funds transfers may be acceptable as a practical means of determining an allocation or attribution of the bank's income, expenses or profit in accordance with Australian PE attribution rules, where it is not possible to trace external source and end use of the borrowed funds.

With respect to foreign bank branches, the operation of Part IIIB of ITAA 1936 effectively allows an Australian branch of a foreign bank to be treated as a separate legal entity and not a PE. Accordingly, certain notional loan and derivative transactions between the branch and head office reflected in the accounting records of the branch are recognised as if they were between separate legal entities. However, interest rates on intra-bank loans are capped at pre-determined levels. The OECD's transfer pricing methodologies and AOA are not applied to these transactions.

Services

In relation to centralised services, consistent with the AOA, the ATO's position is that general management or administrative services performed by a head office for its PEs or vice versa should be allocated on cost basis, i.e., without a profit mark-up. There are exceptions to this policy, for instance, for substantive services or where an entity's sole purpose is the provision of this service, a mark-up may be deemed appropriate.

Risk transfers / Intangibles

Notional financial dealings such as internal derivatives / risk transfers are generally not recognised by the ATO. The ATO's RBA only allows the attribution of actual income, expenses and profit where it is possible to trace external sources of, e.g., income to the use of these funds within the group.

As indicated above, the ATO will recognise internal derivatives relating to interest rate and currency risk (only) between Australian resident financial institutions and foreign PEs in cases where they directly relate to an identifiable external transaction with an unrelated third party (i.e., an external derivative) and the internal derivative allocates the derivative position to the jurisdiction that functionally manages the risk.

4. How is 'free capital' attributed to a PE?

Australia has specific thin capitalisation legislation which requires the Australian branch of a foreign bank to have a minimum capital amount for tax purposes. Where the minimum capital is not held, tax deductions will be disallowed for debt deductions. Australia's thin capitalisation legislation aligns with APRA's capital requirements for authorised deposit taking institutions.

The minimum capital amount for bank branches is the greater of a safe harbour amount (which is broadly 4% of the risk weighted assets attributed to the Australian branch until Basel III reforms are implemented) or, an arm's length capital amount.

TR 2005/11 confirms that the thin capitalisation legislation is intended to be a safe harbour concession, and as such, the ATO considers that appropriate equity attribution requires only an allocation as per properly maintained accounts. The ATO accepts capital attributable as reported in branch accounts.

The safe harbour amount is akin to the quasi thin capitalisation approach to allocating capital. The alternative approach permitted, the arm's length capital amount, is similar to the 'thin capitalisation' approach recommended by the OECD.

5. Are there special documentation requirements for PE dealings?

There are no special documentation requirements for PEs. PEs are expected to maintain documentation to support the manner in which profit has been attributed. This documentation is to the same standard as that required for transfer pricing purposes between separate entities.

6. ***Do you envisage any future developments or changes in relation to transfer pricing for PEs by your local tax authority, including changes in response to the BEPS Action Plan? If so, please detail.***

The Australian Board of Taxation undertook a review of tax arrangements applying to PEs, with a focus on determining the pros and cons of aligning Australia's domestic transfer pricing rules with the OECD AOA. Responses to the discussion paper were submitted in December 2012. The results of this review have not yet been published.

Australia's domestic transfer pricing rules were recently updated (in 2012 and 2013) but Australia's approach to PE attribution was not updated to align with the OECD AOA.

Generally, as the G20 chair in 2014, it is expected that Australia will play a prominent role in determining and driving the BEPS reform agenda. As a member of the OECD, Australia is represented in all of the OECD working groups and committees involved in progressing the OECD/G20 BEPS project. Any changes in response to this work is likely to impact both PEs and separate legal entities.

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India

India

1. What domestic law and transfer pricing-like guidance / rulings have your local tax authorities given on attribution of profits to PEs?

The Indian tax laws do not contain any detailed guidelines or regulations on the issue of profit attribution to PEs. However, as part of domestic law, certain commentary on Section 9(1) of the Income Tax Act, 1962 (the Act) prescribes situations in which income would be deemed to accrue or arise in India only to the extent of operations carried out in India. Further, Rule 10 of the Income Tax Rules, 1962 (IT Rules) is typically applied by the Revenue for determining income in the case of non-residents that are unable to definitely ascertain the income attributable to their India operations. It is worth noting that this rule was drafted much earlier than the detailed transfer pricing laws in India and hence, in the present day, may not have much practical usage.

Over the last two to three years, Indian appellate bodies have emphatically and conclusively pronounced that if the correct arm's length price is applied and paid to a "dependent agent", nothing remains attributable to the PE of a foreign enterprise, and therefore there is nothing left to be taxed in India in the hands of that enterprise. The Mumbai High Court originally took this position in *SET Satellite*, and subsequently the Delhi Tribunal, in *BBC Worldwide Limited*, took a similar view. These rulings followed the principle laid down by the Supreme Court in the context of a service PE in *Morgan Stanley*.

The Delhi High Court in the case of e-Fund Corporation, USA and e-Fund IT Solutions Group Inc., USA (collectively 'the taxpayers'), held that the taxpayers' subsidiary in India by itself did not create a fixed place PE under the India-US tax treaty. The High Court also observed that the mere fact that a non-resident taxpayer sent its employees to provide stewardship activities protecting its interest and ensuring quality and confidentiality, will not make the Indian subsidiary a PE of the non-resident company, even if the employees of the non-resident taxpayer were taken on deputation. It was further held that there was no agency PE since the Indian subsidiary was neither authorised nor habitually exercised authority to conclude contracts, etc.

Recently, the Delhi High Court in *Rolls Royce UK* and *Rolls Royce Singapore* ruled that profit attribution to a PE requires robust transfer pricing analysis. In this case, the High Court ruled that where the activities of the PE in India are remunerated at fair value and this has been taxed in India, there is no question of the assessee being taxed again on the same deemed income. The High Court also held that remuneration paid to an agent could be reasonable and meet the arm's length price criteria if justified by a transfer pricing study. In the present case, since the taxpayer had not maintained a robust functional, asset and risk analysis, the Court was unable to establish whether the remuneration paid to its dependent agent was at arm's length, and, given such limitations, the global formulary approach adopted by Indian tax authorities was accepted to determine higher profits being attributed in India. This ruling confirms the significance of a transfer pricing analysis in determining profit attribution to a PE.

Further, in a first of its kind Ruling in the case of *Credit Lyonnais* on profit attribution to PEs of banks in the context of offshore loans provided by overseas co-branches to Indian borrowers, the Tribunal attributed 20% of the fee component received by the overseas co-branches to the Indian bank branch for the credit analysis function performed by the latter.

Each of the judgments discussed has addressed the ongoing and controversial issue of profits attributable to PEs in India. Where a PE exists, irrespective of the type or nature of the PE, profits must be determined at arm's length, and the judgments have confirmed the need for a transfer pricing analysis. Robust transfer pricing analysis would appropriately analyse the functions performed, risks assumed, assets deployed and value created by the PE, not only on a standalone basis but also in relation to the foreign enterprise as a whole and also vis-à-vis any other group entity in India with which the PE's activities may have any correlation. It is also pertinent to note that soon after the enactment of the transfer pricing law in India in 2001, the definition of 'enterprise' therein was expanded to include PEs of foreign enterprises. In addition to domestic law, treaty provisions warrant application of the arm's length principle for profits attributable to a PE.

2. If adopted, please detail how the AOA has been implemented in your jurisdiction (e.g., enabling legislation, changes to existing treaties).

As covered in the above section.

3. *Do your local rules adopt the separate entity treatment to recognise notional transactions (i.e., dealings) between different PE operations? Specifically:*

- **Trading stock (e.g., inventory)**
- **Intangibles / royalties**
- **Interest**
- **Services**
- **Risk transfers**

Royalties

As regards deductibility of royalties in the hands of an Indian PE, some of India's treaties, such as those with the US and the UK, are restrictive, as the deduction in the hands of the Indian PE will be restricted only to reimbursement of costs incurred by the head office in respect of the items mentioned in those treaties. Other tax treaties signed by India, such as those with Germany, Singapore and the Netherlands, do not impose such restrictions but refer the allowance for such deductions to the provisions of the domestic tax law. The domestic tax law does not contain any specific mention of the deductibility of expenses in the nature of royalties in the hands of a PE in India.

Interest

Tax deductibility of interest paid by foreign bank branches to their head office has always been a contentious issue in India. Past judicial precedents suggested that there cannot be a transaction with self. However, in a more recent ruling on the subject, the Kolkata High Court in the case of *ABN Amro Bank N.V.* has held that interest paid by branches of foreign banks operating in India to their head offices abroad is tax deductible in India, as under the provisions of the tax treaty between India and the Netherlands a branch is considered a PE and the same has to be treated as a separate entity for the purpose of assessment.

Services / head office costs / cost recharges

The Indian transfer pricing regulations do not provide any specific guidance or instances for charging only at cost for intra-group services. The Indian regulations are broadly in line with the principles and methodology enunciated by the OECD's Transfer Pricing Guidelines for Multinational Enterprises (OECD Guidelines). Therefore, Indian taxpayers can make useful reference to the OECD Guidelines where specific guidelines are not provided in the Indian legislation. Further, the Courts and Tribunals in India have often referred to the OECD Guidelines where there is no clarity provided under Indian legislation.

The deductibility of executive and general administrative expenses (i.e., head office expenses) in the hands of Indian PEs is governed by the domestic tax law of India[1], which states that they will be deductible for the PE in India to the extent of 5% of the revenue of the PE or actual expenses attributable to the PE, whichever is lower.

Further, in a few situations, it has been observed that direct costs attributable solely to India operations are also allocated to the PE in India. However, such allocations have been subject to a lot of litigation in India.

Additionally, where an entity's sole purpose is the provision of a kind of service / activity, then in such situations a mark-up could be warranted from an arm's length perspective.

Risk transfers

It has been observed that Indian branches of foreign banks enter into back-to-back arrangements with their head office in order to hedge their own risks and to be compliant with the Federal Bank, i.e., the Reserve Bank of India (RBI) which requires banks to hedge their risks in case of non-Rupee foreign exchange and derivative transactions. Such derivative transactions between the Indian bank branch and its head office reflected in the accounting records of the branch are recognised as if they were between separate legal entities.

In the last concluded transfer pricing audit cycle in India, branches of foreign banks operating in India faced significant audit adjustments on account of such back-to-back arrangements, wherein the revenue authorities have relied on Chapter III of the Report (Global Trading) for attributing a share to Indian bank branch for sales and marketing functions.

4. *How is 'free capital' attributed to a PE?*

In the absence of any provisions in Indian tax laws to determine capital allocable to branches, reliance may be placed on Part II of the Report, which provides specific guidance on how profits from activities such as the borrowing and lending of money might be attributed to PEs of banking enterprises.

The attribution of capital would encompass both 'free capital' and 'non-free capital'; the former being the most critical due to the denial of tax deduction for interest expenses arising from such funds. Free capital is the use of the bank's own financial resources (funds from issuing shares and funds from retained earnings) that do not require the payment of interest.

The Banking Regulation Act of 1949 stipulates a minimum paid-up capital and reserve requirement for banking companies incorporated outside India, i.e., a foreign bank operating in India as under:

(a) the aggregate value of its paid-up capital and reserves shall not be less than Rs. 15 lakhs and Rs. 20 lakhs (for Mumbai or Kolkata or both); and

(b) the banking company shall deposit and keep deposited with the Reserve Bank either in cash or in the form of

1 Section 44C of the Income Tax Act, 1962

unencumbered approved securities, or partly in cash and partly in the form of such securities:

- an amount which shall not be less than the minimum requirement stated in (a) above, and
- after the expiration of each year, an amount calculated at 20% of its profit for that year in respect of all business transacted through its branches in India.

Further, the capital structures of banks are primarily influenced by regulatory requirements. For India, the RBI via its Basel III Capital Regulations has mandated a 9% minimum capital adequacy requirement. This requirement is popularly called capital adequacy ratio (CAR) or capital to risk weighted assets ratio (CRAR).

5. Are there special documentation requirements for PE dealings?

There currently are no special documentation requirements for PE dealings. However, it would be prudent to maintain documentation which would assist in supporting the arm's length pricing from a transfer pricing perspective.

6. Do you envisage any future developments or changes in relation to transfer pricing for PEs by your local tax authority, including changes in response to the BEPS Action Plan? If so, please detail.

There has been no official response to the BEPS Action plan. We are not aware of any statement of the Finance Minister /Officials of the Department of Revenue. However, it is pertinent to note that the current approach taken by the Indian revenue authorities is aligned partially to the BEPS Action Plan themes in aspects as under:

- General Anti Avoidance Rules (GAA) provisions have been enacted and are proposed to come into effect from 01 April 2015.
- Transfer Pricing provisions have been made more stringent and issues such as advertising, marketing and promotions (AMP) and 'location savings' are being applied.
- Further, more treaties incorporating exchange of information (EOI) provisions are being entered into.

The Indian revenue authorities have been extremely aggressive in the transfer pricing audit scrutiny for foreign banks operating in India and have made significant adjustments on account of transactions such as derivatives, cost allocations, etc. undertaken between the Indian bank branch and its head office.

It is also pertinent to state that the recently introduced Advance Pricing Agreement (APA) program in India is gaining momentum and is an important step towards providing certainty to international and Indian investors. Accordingly, many taxpayers are now opting for an APA to obtain certainty on their pricing arrangements with overseas counterparties.

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Japan

Japan

1. What domestic law and transfer pricing-like guidance / rulings have your local tax authorities given on attribution of profits to PEs?

Japan's domestic tax rules and regulations relevant to PEs are contained in:

- Article 141-1 of the Corporate Tax Act
- Article 176(1)-7 of the Corporate Tax Act Enforcement Order

Under Japanese domestic law, a person may be considered to be carrying on business in Japan through a PE either through its own presence in Japan (direct PE) or through the presence of an agent in Japan (agent PE). These provisions of domestic law are broadly the same as in the OECD Model Treaty (Model Treaty).

Under the force of attraction principle of current domestic law, all Japan sourced income, regardless of whether it is attributable to the PE[2], should be subject to full Japanese tax rates in case of a direct PE, upon filing a tax return (so-called entire income method). However, where an agent PE is assessed, attribution rules apply and generally only income attributable to the agent PE is subject to full Japanese taxation.

2. If adopted, please detail how the AOA has been implemented in your jurisdiction (e.g., enabling legislation, changes to existing treaties).

Through the 2014 Tax Reforms promulgated on March 2o, with subsequent Enforcement Orders and Enforcement Regulations promulgated on March 31, the Japanese Ministry of Finance (MOF) has amended Japanese law on the taxation of PEs from the current entire income method to the AOA. Although introduced in the 2014 Tax Reform, the AOA will only be effective for fiscal years beginning on or after 1 April 2016. Until that time, the existing law will apply.

The amendments introduced by the MOF are designed to be consistent with the revised Model Treaty and the Report, as well as trends in international tax law and practice. As a result of this enactment, there are significant changes for both the taxable income calculation of Japan branches of foreign corporations, as well as the computation of foreign tax credits for Japanese corporations.

Under the new law, the attributable income of the PE would be calculated based on the functional and factual analysis of the PE by (i) allocating assets, risks and capital to the PE, (ii) recognising intra-entity dealings, and (iii) hypothesising the dealings as if the PE were a separate and independent enterprise:

- For capital allocation, the new law introduces two applicable methods - the 'capital allocation approach' or the 'thin capitalisation approach'. A 'safe harbour approach' that is used for the supervision and regulation of financial institutions is not permitted.
- Based on the concepts underlying the new Article 7 of the Model Treaty and set out in the OECD's 2010 Report, an appropriate level of capital of the enterprise will be allocated to the PE so that interest deductions are subject to limitations when calculating a PE's attributable income. Such interest deduction limitations will apply even where it is apparent that the PE's funding is entirely financed by third party loans.
- Profits or losses arising from intra-entity dealings will be recognised for transactions that the PE would have earned at arm's length as if it were a separate and independent enterprise. Such dealings will have to be documented.
- Recognition of profit or loss from intra-entity dealings will not arise when the profit or loss of the entity is realised but when the intra-entity dealing takes place.
- Settlement of a payable or receivable arising from intra-entity dealings will not be required.
- Where the transaction price arising from an intra-entity dealing differs from that under arm's length terms, the price will be adjusted to the arm's length price.

3. What is the current treatment of the following notional transactions between a head office and its PE? Specifically:

- **Trading stock (e.g., inventory)**
- **Intangibles / royalties**
- **Interest**
- **Services**
- **Risk transfers**

Within its use of the entire income method, Japan has generally applied a form of separate enterprise theory or degree of the contribution by the PE, to calculate Japan sourced income for the PE as the "portion" of the enterprise's business income to be earned by that PE[3]. However, there has been no further

2 Article 141-1 of the Corporate Tax Act and Article 176(1)-7 of the Corporate Tax Act Enforcement Order.

guidance as to how this separate enterprise theory should be applied.

Inter-branch transactions are generally not respected, and while deduction of certain costs incurred for the purposes of the business in Japan is permitted by the PE, this does not include all expenses arising from dealings with another part of the enterprise to which the PE belongs. For example, deductibility is denied for interest expenses on funding or on royalty payments from use of intangible assets provided by head office (or another PE).

In practice an exception is made to permit the deductibility of interest payments by bank branches in Japan. However, this is not legislated and is only permitted up to the amount of LIBOR.

4. *How is 'free capital' attributed to a PE?*

In Japan, internal funding costs paid to head office are currently not deductible in determining the profit of a PE. However, where the funding costs of the PE can be traced directly to a third party finance provider other than the head office, interest may be deductible; in which case, Japan limits the use of related party debt through its thin capitalisation and earnings stripping rules, and the interest must be arm's length.

5. *Are there special documentation requirements for PE dealings?*

There currently are no special documentation requirements for PE dealings.

6. *Do you envisage any future developments or changes in relation to transfer pricing for PEs by your local tax authority, including changes in response to the BEPS Action Plan? If so, please detail.*

Japan's finance minister Mr. Aso has declared support for the OECD's BEPS Action Plan. However, Japanese multinationals tend to be conservative in their tax planning relative to foreign multinational corporations. Therefore, as a group, Japanese multinationals may be less impacted than foreign corporations.

Nevertheless, the Japanese government is currently aligning its law with general OECD principles, and BEPS is another step in that process. Therefore, although the BEPS timeline is long and although it is not yet clear what action the Japanese government may take, there may be changes in the Japanese law to reflect BEPS initiatives. Moreover, Japanese corporations operating in overseas jurisdictions may well be impacted by law changes made as a result of BEPS by foreign governments.

3 Article 176(1)-7 of Corporate Tax Act Enforcement Order.

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Korea

Korea

1. What domestic law and transfer pricing-like guidance / rulings have your local tax authorities given on attribution of profits to PEs?

The calculation of the corporate income tax base for a PE is similar to the method for determination of the tax base for a company incorporated in Korea. Also head office expenses that relate to the derivation of the PE's business income may be allocated to the PE and claimed as a deduction.

The deductibility of interest expense for a bank branch is subject to the deemed capitalisation rule discussed below.

2. If adopted, please detail how the AOA has been implemented in your jurisdiction (e.g., enabling legislation, changes to existing treaties).

The AOA has been adopted by clarification of the Corporate Income Tax Act (CITA), effective from January 1, 2014. (Article 130 of the Presidential Decree (PD) of the CITA)

3. What is the current treatment of the following notional transactions between a head office and its PE? Specifically:

- **Trading stock (e.g., inventory)**
- **Intangibles / royalties**
- **Interest**
- **Services**
- **Risk transfers**

Under Article 130 of the PD of the CITA, all transactions between a head office and its PE should be recognised on an arm's length basis for tax purposes except for the following:

- Interest expense on loans to a non-bank branch
- Guarantee fees

4. How is 'free capital' attributed to a PE?

The thin capitalisation rule and the deemed capitalisation rule (for bank branches only) are applied to the attribution of 'free capital' for tax purposes.

Thin capitalisation rule

Under Article 14 of the Law for the Coordination of International Tax Affairs (LCITA), interest expense attributable to borrowings in excess of the safe harbour debt to equity ratio (3 to 1 generally, 6 to 1 for financial institutions, or the "arm's length" ratio) from a Foreign Controlling Shareholder (FCS) and debt borrowed from a third party based on the guarantee of the FCS, shall not be allowed as deductible interest expenses in computing taxable income of a domestic corporation or a Korean PE of a foreign corporation.

Deemed capitalisation rule

Bank branches are also subject to the 'deemed capital' rule which broadly deems borrowings from head office in excess of the head office's debt to asset ratio to be capital on which the interest expense is not deductible. Where both the thin capitalisation and deemed capital rules apply, only the excess of non-deductible interest expense under the deemed capital rule over the non-deductible interest expense under the thin capitalisation rule is non-deductible.

5. Are there special documentation requirements for PE dealings?

There are currently no special documentation requirements for PE dealings except for the details of the allocation of head office expenses to be attached to corporate income tax returns.

6. Do you envisage any future developments or changes in relation to transfer pricing for PEs by your local tax authority, including changes in response to the BEPS Action Plan? If so, please detail.

While it is too early to tell at this stage, any recommendations from the BEPS Action Plan are likely to be considered by the Korean tax authorities in the course of proposing tax amendments which are generally made on an annual basis.

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Malaysia

Malaysia

1. What domestic law and transfer pricing-like guidance / rulings have your local tax authorities given on attribution of profits to PEs?

Malaysia's domestic tax law currently taxes any person, including a PE, on income accruing in, or derived by the person from, Malaysia, i.e., on a territorial basis with the exception of resident companies carrying on the business of banking, insurance, shipping and air transport, where income is taxed on a worldwide basis. For countries with which Malaysia has a tax treaty, the PE rules in the treaty will govern the treatment of profits of a PE in Malaysia. The PE rules in the treaty are generally in alignment with Malaysia's domestic tax law.

General transfer pricing rules are provided in section 140A of the Income Tax Act 1967. With effect from 1 January 2009, section 140A empowers the Director General of the Inland Revenue Board (DGIR) to make adjustments on transactions of goods, services or financial assistance carried out between associated persons based on arm's length price. The Income Tax (Transfer Pricing) Rules 2012 (the TP Rules) and the Transfer Pricing Guidelines 2012 (the TP Guidelines) provide further guidance on the mechanics of section 140A.

The TP Rules and the TP Guidelines are largely based on the OECD Guidelines with some modification to ensure adherence to the Income Tax Act 1967 and domestic circumstances. The two main differences are in the methods to determine arm's length price and the frequency for testing of prices for arm's length purposes.

The DGIR generally requires the traditional transactional methods (e.g., comparable uncontrolled price method / the resale price method / the cost plus method) to be used first. It is only when these methods cannot be applied that the taxpayer is permitted to use the transactional profit methods (e.g., profit split method / the transactional profit method). Other methods may be used only when all the aforementioned methods cannot be applied. The DGIR also requires taxpayers to test transfer prices for arm's length purposes on an annual basis.

2. If adopted, please detail how the AOA has been implemented in your jurisdiction (e.g., enabling legislation, changes to existing treaties).

The AOA has not been implemented in Malaysia.

3. What is the current treatment of the following notional transactions between a head office and its PE? Specifically:

- **Trading stock (e.g., inventory)**
- **Intangibles /royalties**
- **Interest**
- **Services**
- **Risk transfers**

Under both the TP Rules and the TP Guidelines, a PE will be treated as a (hypothetically) distinct and separate entity from its head office and related branches.

There are specific provisions in the TP Rules and TP Guidelines dealing with intangibles, interest and services:

Intangibles / royalties

An arm's length price for licensing of the intangible property must be charged by the licensor. The arm's length pricing is considered from the licensor's and the licensee's perspectives. The licensor needs to take into account the recovery of costs associated with the development of the intangible whilst the licensee must consider the expected benefits the intangible is expected to generate.

Interest

Interest charged on financial assistance given by a head office to its branches, including loans, interest bearing trade credits, advance or debt, is can be deducted by the branch to the extent that the interest charged is consistent with that charged in similar transactions between independent persons dealing at arm's length. The DGIR will make adjustments where the interest rate imposed is not at arm's length or no interest is charged.

Services

Charges for services must reflect the relative benefits intended by the services, consistent with those charged in similar transactions between independent persons dealing at arm's length.

Certain services are disregarded. Examples of disregarded services include shareholder activity relating to the reporting and legal requirements of the parent company (e.g., preparation of consolidated accounts and filing of prospectuses) or duplicative services.

It is preferred that the service provider adopts the direct charge method. However, if the direct charge method cannot be applied, the indirect charge method may be used and the

allocation key must be appropriate for the nature and purpose of the service provided; for example the provision of payroll services may use an allocation key based on the number of staff. An allocation key based on sales is generally not accepted by the DGIR unless the taxpayer is able to justify the correlation between sales and costs incurred.

Trading stock / risk transfers

The TP Rules or TP Guidelines do not have specific provisions that deal with trading stock or risk transfers but the arm's length principle is generally required to be applied on prices for trading stock or risk transfers. Risk transfers are however not likely to be seen between a head office and its PE.

4. How is 'free capital' attributed to a PE?

Thin capitalisation was introduced in the Malaysian Income Tax Act 1967 on 1 January 2009 through Section 140A(4). Section 140A(4) empowers the DGIR to disallow any interest, finance charge or other consideration payable for, or losses incurred in relation to, the amount of financial assistance which the DGIR deems excessive in relation to the fixed capital.

The implementation of thin capitalisation has however been deferred to 31 December 2015.

5. Are there special documentation requirements for PE dealings?

No special documentation is currently required for PE dealings. PEs are expected to maintain transfer pricing documentation similar to the documentation required for dealings between separate entities.

6. Do you envisage any future developments or changes in relation to transfer pricing for PEs by your local tax authority, including changes in response to the BEPS Action Plan? If so, please detail.

As the DGIR continues to develop and refine the transfer pricing framework in Malaysia, it is expected that there will be changes to the Malaysian transfer pricing landscape in the future, to take into account the BEPS Action Plan.

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Singapore

Singapore

1. What domestic law and transfer pricing-like guidance / rulings have your local tax authorities given on attribution of profits to PEs?

Singapore taxes refer to the source of income rather than the presence of a PE. Hence, the presence of a PE is largely irrelevant except for treaty and withholding tax purposes. However, a PE is a clear indication of source.

The definition of a PE in Singapore's tax treaties is largely based on the OECD Model Tax Convention definition. It is generally taken to be a fixed place through which the business of an enterprise is wholly or partly carried on, and normally includes a place of management, a branch, an office, a factory, a workshop, and a place of extraction of natural resources, etc. In addition, and subject to the terms of the relevant agreements, a non-resident may also have a PE in Singapore if one:

- has a building site or a construction, assembly, or installation project that lasts longer than a specified number of months, or supervisory activities connected with the building site or construction project
- furnishes services (including consultancy services) through employees in Singapore for more than a specified number of days or months, or
- has an agent in Singapore who has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of the enterprise.

The Singapore tax legislation defines a PE more broadly than most tax treaties. This definition is relevant only where there is no treaty.

Singapore's domestic tax rules and regulations relevant to PEs are contained in the following:

- Income Tax Act and Regulations (see in particular, sections 2, 10, 12 and 34D of the Income Tax Act)
- Transfer Pricing Guidelines
- Transfer Pricing Guidelines for Related Party Loans and Services

Where a non-resident person carries on a trade or business of which only part of the operations is carried on in Singapore, the gains or profits of the trade or business shall be deemed to be derived from Singapore to the extent to which such gains or profits are not directly attributable to that part of the operations carried on outside Singapore.

For transfer pricing purposes, where a person carries on business through a PE, the person and the PE are treated as two separate and distinct persons.

2. If adopted, please detail how the AOA has been implemented in your jurisdiction (e.g., enabling legislation, changes to existing treaties).

The AOA has not been formally adopted in Singapore. In practice, the Singapore tax authorities treat a PE as a separate and independent enterprise from its head office, and recognise intra-entity/inter-branch dealings.

3. What is the current treatment of the following notional transactions between a head office and its PE? Specifically:

- **Trading stock (e.g., inventory)**
- **Intangibles / royalties**
- **Interest**
- **Services**
- **Risk transfers**

A PE is treated as a separate and independent enterprise from its head office. Profits or losses arising from intra-entity dealings would be recognised based on the amounts that the PE would have earned at arm's length as if it were a separate and independent enterprise. Such dealings would have to be documented. Where the transaction price arising from an intra-entity dealing differs from that under arm's length terms, the price would be adjusted to the arm's length price.

4. How is 'free capital' attributed to a PE?

Interest incurred on capital employed in the production of income, and borrowing costs that are incurred as a substitute for interest or to reduce interest costs, will be allowed as a tax deduction.

There are no formal thin capitalisation rules in Singapore. That said, it is important to ensure that the arm's length requirement is met. General anti-avoidance and transfer pricing provisions may operate in cases of abuse.

There are no specific rules for attributing 'free capital' to a PE. In practice, interest expense deduction is restricted to the extent it is attributable to non-trade and non-income producing assets.

5. Are there special documentation requirements for PE dealings?

There are no special documentation requirements for PEs. PEs are required to maintain documentation to support, among other things, the manner in which profit has been attributed. The documentation requirements for PEs are the same as those for companies/separate entities.

6. Do you envisage any future developments or changes in relation to transfer pricing for PEs by your local tax authority, including changes in response to the BEPS Action Plan? If so, please detail.

There have been no formal announcements on changes to transfer pricing for PEs by the Singapore tax authorities. The Singapore government is following the BEPS Action Plan developments closely. While it is likely that Singapore will adopt international norms, it is not yet clear what action the Singapore government may take to reflect the full extent of BEPS initiatives.

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Taiwan

Taiwan

1. What domestic law and transfer pricing-like guidance / rulings have your local tax authorities given on attribution of profits to PEs?

Taiwan's domestic provisions relevant to PEs are contained under:

- Article 10 of the Income Tax Act
- Article 41 of the Income Tax Act

Under Taiwanese domestic law, the term 'fixed place of business' and 'business agent' stated in Article 10 of the Income Tax Act are broadly similar to the concept of permanent establishment in the OECD Model Tax Convention.

- Fixed place of business refers to fixed places for the operation of business, including administrative offices, branch or sub-branch offices, business offices, factories, workshops, warehouses, mining fields, and construction sites. It excludes, however, warehouses or maintenance shops used exclusively for the purchase of goods, and not used for processing or manufacturing products.
- A business agent refers to an agent that performs any one of the following functions:

(1) Where the agent, in addition to representing its principal in the purchase of goods, is authorised to regularly represent the principal in making business arrangements and in signing contracts; or

(2) Where the agent regularly keeps in store goods of its principal and delivers the same, for its principal, to others; or

(3) Where the agent regularly accepts, for its principal, orders for goods.

(In general, the concept of goods also applies to 'services'.)

Under Article 41 of Income Tax Act, if a profit-seeking enterprise whose head office is outside the territory of Taiwan has a fixed place of business or business agent located inside the territory of Taiwan, the fixed place of business or business agent shall keep separate accounting books and its profit-seeking enterprise income tax shall be assessed accordingly.

For a profit-seeking enterprise whose head office is not located in the territory of Taiwan, the fixed place of business or business agent in the territory of Taiwan shall assess income tax on the separate accounting books for income derived within the territory of Taiwan.

2. If adopted, please detail how the AOA has been implemented in your jurisdiction (e.g., enabling legislation, changes to existing treaties).

The AOA has not been officially adopted in domestic tax laws. However, where tax treaties are in place, Article 18 of the Regulations Governing Application of Agreements for the Avoidance of Double Taxation with Respect to Taxes on Income ("DTA Guideline") applies the concept of AOA approach in determining the profits attributable to PE under the treaty between Taiwan and countries signing the treaty with Taiwan ("Contracting State").

Under Article 18 of the DTA Guideline, where an enterprise of the other Contracting State carries on business in the territory of Taiwan through a PE[4] situated therein, the business profits which are attributed to such PE shall be determined in accordance with the following provisions and be subject to income tax accordingly:

1. The PE shall be treated as if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of the other Contracting State of which it is a PE. The profits attributable to the PE shall be determined in accordance with the provisions of the 'Regulations Governing Assessment of Profit-Seeking Enterprise Income Tax on Non-Arm's Length Transfer Pricing' (i.e., Taiwan's transfer pricing assessment rules), and documents shall be prepared which are sufficient to prove that the attributable profits are determined in accordance with the arm's length transfer pricing principle for assessment by the tax collection authority-in-charge. Where the enterprise of the other Contracting State attributes the overall profits deriving from the territory of Taiwan by the sale of goods or products or provision of services therein to such PE of the enterprise, the profits to be attributed to the PE may be determined without the requirement to provide the transfer pricing documents.

2. Where the enterprise of the other Contracting State is allowed to deduct expenses which are incurred for the purpose of the operation of the PE, in determining the profits of a PE, such determination shall be governed by the relevant provisions of the Income Tax Act, the 'Guidelines for Examination of Profit-Seeking Enterprise Income Tax', the 'Regulations Governing Assessment of Profit-Seeking

4 The definition of PE may vary with minor differences under applicable treaties signed between Taiwan and other countries.

Enterprise Income Tax on Non-Arm's Length Transfer Pricing', and other relevant laws or regulations.

3. *What is the current treatment of the following notional transactions between a head office and its PE? Specifically:*

- **Trading stock (e.g., inventory)**
- **Intangibles / royalties**
- **Interest**
- **Services**
- **Risk transfers**

Under Article 3 of the Income Tax Act, for any profit-seeking enterprise having its head office outside of the territory of Taiwan but having income derived from sources in Taiwan, profit-seeking enterprise income tax shall be levied on its Taiwan-source income.

As mentioned above, per Article 41 of Income Tax Act, if a profit-seeking enterprise whose head office is outside of the territory of Taiwan has a fixed place of business or business agent located inside the territory of Taiwan, the fixed place of business or business agent shall keep separate accounting books and its profit-seeking enterprise income tax shall be assessed accordingly. In practice, Taiwan has generally applied a form of separate enterprise theory to calculate the Taiwan sourced income of the head office and the PE, respectively. In addition, while determining the profits of the PE, expenses incurred for the purpose of establishing / maintaining the PE are allowed as a deduction for tax purposes.

For intra-group service transactions occurring between the PE and head office, head office and the PE should calculate the service fee with a profit mark-up in accordance with the transfer pricing regulations and prepare sufficient information for audits by the tax authority. Likewise, the same procedure applies to intangible / royalties charges when an authorising transaction occurs between the PE and head office.

4. *How is 'free capital' attributed to a permanent establishment?*

In Taiwan, relevant tax laws are silent on the treatment of free capital. Interest paid to a head office is deductible in determining the profit of a PE/fixed place of business (e.g., branch). Taiwan limits the use of related party debt through its thin capitalisation rules (related party debt to equity ratio of 3:1)[5], and the interest must be arm's length.

5. *Are there special documentation requirements for permanent establishment dealings?*

There currently are no special documentation requirements for PE dealings. Relevant documents to substantiate taxable revenues and deductible expenses are generally stipulated in the Income Tax Act and relevant transfer pricing assessment rules.

6. *Do you envisage any future developments or changes in relation to transfer pricing for PEs by your local tax authority, including changes in response to the BEPS Action Plan? If so, please detail.*

Taiwan is not officially a member of OECD. However, the Taiwan tax authority is paying close attention to BEPS developments and may consider adopting some of the rules/methods in domestic tax laws in the future.

5 Taiwan thin capitalization rule is stipulated in Article 43-2 of Income Tax Act.

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Thailand

Thailand

1. What domestic law and transfer pricing-like guidance / rulings have your local tax authorities given on attribution of profits to PEs?

Under Thai domestic law, the two sections that govern the tax liabilities of foreign companies carrying on business in Thailand, are Section 66 Paragraph 2 and Section 76 bis of the Revenue Code.

Section 66 Paragraph 2 applies to foreign companies that operate their business through a branch in Thailand. Section 76 bis, on the other hand, applies to foreign companies having an employee, a representative or a go-between in Thailand to derive income or gains in Thailand. It should be noted that Section 76 bis does not apply in the case of independent agents.

Under Section 66 Paragraph 2, the 'Limited Force of Attraction Rule' applies, under which all Thai sourced income is taxed regardless of whether it is attributable to the PE, provided that the transactions carried on by the non-resident are of the same or similar kind as carried on through the PE.

As for Section 76 bis, each type of transactions has a different profit attribution approach. Transactions should be classified into the three following types:

1. Sale of goods;
2. Provision of services other than provision of loans; and
3. Provision of loans

The Limited Force of Attraction Rule applies to the sale of goods and provision of loan categories, whilst the 'Attribution Rule' applies to the provision of services other than provision of loans.

The allocation of costs from head office to branch must conform with Departmental Instruction Paw.13/ B.E. 2529 Clause 2 Paragraph 2, which states that:

> In respect of expenses which a branch in Thailand pays to its head office or to another branch in a foreign country as compensation for the assistance or services given or rendered for the benefit of the business of the Thai branch, such expenses may be treated as expenses for the computation of net profits, and not treated as non-deductible expenses, only if there exists clear evidence that such expenses answer to the following descriptions:
>
> 1) the expenses are made in connection with the assistance or services given or rendered by such head office or branch relating to the business of the Thai branch;
>
> 2) the research and development expenses are made for the Thai branch, or the results of such research and development are actually applied for the benefit of the business of the Thai branch;
>
> 3) any expenses which have already been treated as expenses in the computation of net profits of the head office or another branch may not again be treated as expenses of the Thai branch;
>
> 4) the allocation of the expenses made by the head office or another branch to the Thai branch must conform to the generally accepted rules and methods, and must also be consistently applied to the branches in other countries; and
>
> 5) the expenses do not belong particularly to the head office or another branch, such as office rentals, water and electricity charges, stationery expenses, cost of appliances, wear and tear and depreciation of appliances or equipment.

The expenses in the amounts, and according to the rules and methods, described in the second paragraph must, in order to be includible as expenses of the Thai branch be substantiated by documents or certificates issued by the appropriate authority of the foreign government concerned, or by other reliable persons acceptable to the Director-General of Revenue, and such documents or certificates must contain information in sufficient detail to show that they are genuinely necessary and reasonable expenses for the conducting of business of the Thai branch.

For non-resident companies located in countries with which Thailand has a treaty, the PE rules in the treaty override domestic law and govern the treatment of profits taxable in Thailand.

In the case where the profits arising from sales made in Thailand by a foreign company cannot be ascertained, whether or not it is located in a country with which Thailand has a treaty, the Revenue Department will have the power to assess corporate income tax, at a rate of 5%, on gross sales or gross revenues, whichever is greater, in lieu of 20% corporate income tax on net profits and 10% profit remittance tax.

2. *If adopted, please detail how the AOA has been implemented in your jurisdiction (e.g., enabling legislation, changes to existing treaties).*

The AOA has not been adopted in Thailand, not even for cases where treaties provide for the distinct and separate enterprise concept.

3. *What is the current treatment of the following notional transactions between a head office and its PE? Specifically:*

- **Trading stock (e.g., inventory)**
- **Intangibles / royalties**
- **Interest**
- **Services**
- **Risk transfers**

Charges between a head office and its branch are generally disallowed for corporate income tax purposes, except for those relating to general management or administrative services performed by a head office for its PEs or vice versa. These expenses should be allocated on a cost basis, i.e., without a profit mark-up. Certain specific expenses, e.g., office rent, water, and electricity charges, stationery expenses, cost of appliances, wear and tear and depreciation of appliances or equipment may not be claimed as tax deductible expenses of the Thai branch under Paw. 13/B.E. 2529.

In respect of the banking industry, an exception is also made to permit the deductibility of interest and other fees related to the business undertaking of the Thai branch paid to a head office by the Thai branch under the relevant tax treaty.

4. *How is 'free capital' attributed to a PE?*

Internal funding costs paid to a head office are currently not tax deductible for a PE in Thailand. However, where the funding costs of a PE can be traced directly to a third party finance provider other than the head office, interest would be deductible under the relevant treaty.

5. *Are there special documentation requirements for PE dealings?*

There are currently no special documentation requirements for PE dealings.

6. *Do you envisage any future developments or changes in relation to transfer pricing for PEs by your local tax authority, including changes in response to the BEPS Action Plan? If so, please detail.*

The Thai tax authorities are reviewing the BEPS Action Plan proposed by the OECD. Release of the Revenue Department's position regarding BEPS is not expected in the near future, however.

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Memo