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Ms Ronita Ram
Acting Assistant Secretary
Tax Treaties Branch
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Treasury
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By email: MNETaxIntegrity@treasury.gov.au

Dear Ms Ram,

Denying deductions for payments relating to intangible assets connected with low corporate tax jurisdictions

The Corporate Tax Association (**CTA**) welcomes the opportunity to make a submission to Treasury on the *Treasury Laws Amendment (Measures for Consultation) Bill 2023: Deductions for payments relating to intangible assets connected with low corporate tax jurisdictions* exposure draft (**ED**) and the accompanying Explanatory Materials (**EM**). We also thank you for the opportunity to discuss the measure this afternoon.

The CTA is the key representative body representing over 150 of the major companies in Australia on tax issues impacting the large corporate sector. The majority of the CTA membership is large Australian listed entities. A list of CTA members and further information about the CTA can be found on our website at www.corptax.com.au.

The CTA is a longstanding, respected participant in consultation on tax matters impacting large corporates. We approach all consultation processes openly and with respect for the Government's stated policy.

Unfortunately, adopting our usual approach to consultation in terms of understanding and respecting the Government's stated policy has been virtually impossible in the context of this proposed measure. Its parameters, key terms and focus areas have gone through a number of iterations, most of which have added further confusion and concern around deciphering its intended purpose[1].

Aside from the Government's commitment to a start date of 1 July 2023, we remain confused about what problem this proposed measure is intended to address. A clear request in our submission on the Multinational tax integrity and enhanced transparency consultation paper (**CP**) for the ATO to articulate its concerns around existing structures and why the extensive suite of existing anti-avoidance measures is ineffective in addressing its concerns have not been forthcoming. Instead, we have been presented with a proposed

[1] See further our comments under the title 'Background' on page 2 of this submission.

rule which has prompted irate responses from multiple international sources, asking why Australia is pursuing a unilateral attack on legitimate transactions via the introduction of a measure that is more draconian in potential impact than the Diverted Profits Tax (but without a purpose test or substance based carve-out) and pre-empts global agreement on Pillar Two.

While we accept the election commitment of a 1 July 2023 start date for this measure, to proceed with it in its current form disadvantages Australian companies and would result in embarrassment for the Government which has publicly committed to pursuing multilateral solutions to global problems.

Background

This measure, as originally announced by the government as an election commitment, was aimed at 'abuse' of Australia's treaty network by targeting treaty shopping by multinationals to funnel payments for the use of intellectual property in tax havens with low rates of tax[2]. It was subsequently expanded in scope in a joint media release[3] announcing the release of the CP in August 2022 (where this and other international tax measures were first explored) to include embedded royalties and removed the reference to tax havens.

The CP proposed a bright line test in addition to existing specific and general anti-avoidance provisions, transfer pricing reconstruction provisions and treaty shopping provisions to counter arrangements set out in two ATO Taxpayer Alerts that were focused on non-arm's length arrangements connected with developing, enhancing and exploiting intangible assets (TA 2020/1) and mischaracterising payments connected with intangible assets (TA 2018/2). These examples could be viewed as extreme taxpayer behaviour.

Our concerns with the CP proposal were that a bright-line test would apply very broadly to genuine commercial arrangements that do not involve any mischief and would impose a significant, unnecessary compliance burden on many taxpayers disproportionate to the perceived abuse of Australia's tax treaty network to funnel payments for the use of intellectual property to low tax jurisdictions the proposed measure is aimed at. It was entirely unclear whether a separate rule over and above existing anti-avoidance and integrity rules was even warranted or whether the perceived mischief was rife.

The October 2022-23 Budget announcement proposed the government would introduce an anti-avoidance rule "to prevent significant global entities (entities with global revenue of at least $1 billion) from claiming tax deductions for payments made directly or indirectly to related parties in relation to intangibles held in low- or no-tax jurisdictions". A low or no tax jurisdiction would be determined based on whether it had a tax rate of less than 15% or a tax preferential patent box regime that didn't have sufficient economic substance.

In our view, the ED suffers from the same issues identified with the CP proposal – it will apply to genuine commercial arrangements that do not involve any mischief and would impose completely unwarranted compliance costs on those taxpayers. A Significant Global Entity (SGE) may have its origins in a low tax jurisdiction and could not have structured its arrangements to avoid corporate income tax simply because it decided to expand its operations to Australia. The ED affords no scope for reasonable or rational consideration

[2] See the policy extract on p10 of our submission titled Government election commitments: Multinational tax integrity and enhanced tax transparency – September 2022.
[3] https://ministers.treasury.gov.au/ministers/jim-chalmers-2022/media-releases/public-consultation-begins-multinational-tax-integrity

of relevant circumstances. As noted above, we are also still in the dark as to the extent of the mischief this proposed rule intends to address and why that mischief is not captured within the parameters of the extensive, existing suite of anti-avoidance rules including transfer pricing, the DPT, the MAAL, CFC rules, treaty shopping rules and Part IVA. The measure effectively overlaps with these existing rules.

When you add to this extensive list the proposed rules on Pillars One and Two (in particular), one must seriously question the need for a further rule that by its nature will be a compliance nightmare for related party arrangements priced on arm's length principles where there is no tax avoidance motive.

The proposed anti-avoidance test reverses sequencing of the Pillar Two Model Rules and can lead to double tax

Due to its broad design, the practical effect of the proposed rule is to completely undermine the Pillar Two Model Rules and the timing and sequencing of the income inclusion rules and undertaxed profits rules. In our view, it is wholly pre-emptive, reactionary and misconceived to have this rule potentially apply in such cases.

In effect, the proposal is a pre-emptive Pillar Two undertaxed profits rule operating in effect from 1 July 2023. That is, before a low tax jurisdiction has the ability to increase its corporate rate to a minimum of 15%, or a home jurisdiction implements an income inclusion rule under the GloBE rules, Australia has decided to pre-empt international consensus and take potential tax revenue from other countries by unilaterally applying a blunt undertaxed profits rule (that does not appear to factor in any attribution or taxation of the income under the CFC rules) under the guise of an anti-avoidance rule.

We say this as the proposal operates in practice to reverse the timing of the implementation of the Pillar Two Model Rules by having the agreed "backstop" undertaxed profits rule (the current proposal), (along with a few select elements of the Subject to Tax rule), apply before any income inclusion rule and furthermore at an earlier date.[4] There is nothing in the ED or EM to indicate the proposed rule will not apply after Pillar Two is implemented. In fact, should an income inclusion rule of a foreign jurisdiction apply to tax low tax profits in the home country, there is nothing in the current design of the proposal to avoid the amount paid by an Australian entity to a low tax jurisdiction not being deductible in Australia and also taxable under Pillar Two – the result is of course double tax, or at the very least asymmetrical tax treatment of the amount paid.

As a minimum, the proposed rule (in a form that aligns with the alternative suggestion below) must sunset when Australia adopts Pillar Two[5]. This should be noted in the ED and EM. Further, if the amount to which proposed section 26-110 applies is 'attributable income' of the SGE under the Australian CFC rules, the payment should not be treated as non-deductible.

A targeted and aligned anti-avoidance rule – at most

Though we consider the proposed rules entirely unnecessary, as noted above we acknowledge the government has made an election commitment to pursue some type of anti-avoidance measure. In the attached Appendix, we provide more detailed comments on the proposed rules and offer suggestions for developing a clearly targeted, easy-to-

[4] See Pillar Two Model Rules in a Nutshell (oecd.org)

[5] It should also not apply if a foreign jurisdiction has implemented Pillar Two before Australia does.

apply integrity rule that is fit for purpose and only captures arrangements designed to avoid income tax / withholding tax.

Our suggestion is for a two-pronged test, similar to that proposed for the recent equity raisings to fund distributions measure. This involves:

- a 'purpose' test; and
- a principal effect test (a 15% minimum tax threshold),

to be satisfied before the test applies to deny a tax deduction.

This rule would then sunset once Pillar Two Rules are implemented in Australia to ensure Australia is not undermining the intent of the Pillar Two principles.

A clear, aligned and understood definition of 'low corporate tax jurisdiction' must be the starting point

To pursue this type of anti-avoidance rule with a convoluted approach to determining which jurisdictions are potentially captured is completely unacceptable and is an affront to multilateral cooperation on international tax matters. It is equally objectionable as it does not recognise another country's sovereign right to have a Federal legal system that allows corporate tax to be imposed at a Federal and State (or in the case of Switzerland - Cantonal level), particularly in cases when the effective combined corporate tax rate and the Federal and State (or Cantonal level) is above 15%.

Creating our own bespoke approach to inclusions and exclusions on the basis of legitimate tax outcomes in jurisdictions simply because our tax administrator doesn't like it or like the outcome under the proposed Pillar Two rules, is not an acceptable basis for tax policy formulation and must be resisted. SGEs by their nature operate globally, so a 'uniquely Australian' domestic concept that applies to Australian companies in isolation is not workable.

A clear approach to determining what a 'low tax corporate jurisdiction' is which aligns with other such approaches, such as that taken under Pillar Two, must be the starting point for any proposed rule.

Should you have any questions, please do not hesitate to contact Michelle de Niese on 0402 471 973 or Paul Suppree on 0408 185 050.

Yours sincerely,

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Appendix

1. Defining a low corporate tax jurisdiction – section 960-258

- Rate of corporate income tax – It is unclear what taxes are intended to comprise the 'rate of corporate income tax' in subsection 960-258(1)(a) for the purpose of determining whether the rate of the foreign country is less than 15% or nil. It is also not clear whether the definition of low corporate tax jurisdiction is looking at the tax treatment of relevant amounts of in-scope revenue or just looks at whether a jurisdiction offers special tax rates regardless of whether they could potentially apply to in-scope revenue or not.

  We note the EM at paragraph 1.55 says only national level corporate tax is relevant for making this determination. However, this disregards the fact that numerous jurisdictions don't necessarily apply corporate taxes at a national level only.

  Subsection 960-258(2) sets out in fairly complex terms what rates and features of the foreign country's corporate tax system should be considered and disregarded. This means there are a variety of rates and concessions that need to be considered even if they are not related to intangible incomes. Such an exercise will be onerous on taxpayers and would give rise to arbitrary and non-sensical outcomes with many countries in the world being taken to be low tax jurisdictions.

  For example, hubs where intellectual property (IP) is commonly held such as in Singapore, Hong Kong or the US may have a headline corporate tax rate higher than 15% but may have concessions that apply for holding IP there that may lower the overall applicable rate. Hong Kong has a corporate tax rate as low as 8.5% for the first $2 million held there. The corporate rate in Switzerland can vary between 11.9% to 21%. The corporate tax rate in Germany is 15%. Other countries offer tax incentives and tax holidays. This is a complicated analysis to undertake.

  It is also unclear how concessions or exemptions of certain income from inclusion in taxable income should be treated. For example, a participation exemption on capital gains derived by a foreign associate isn't covered by subsection 960-258(2)(a) but is also arguably not covered by subsection 960-258(2)(d) because no income tax is applied to a step in working out your taxable income, income tax is only applied to the result of all of those steps, at the headline rate. Put another way, if the headline rate of 25% is applied to taxable income, but taxable income excludes income from a capital gain where certain criteria are satisfied or excludes income of a foreign PE, is the rate nil under subsection 960-258(2)(d) or are these items disregarded?

  This analysis is unproductive and contradicts globally agreed OECD concepts.

  Rather than require such an analysis, we suggest that reference be made to the taxes intended to be included in the Pillar Two 'Covered Taxes' definition in Article 4.2 of the OECD Model Rules[6]. This is sensible as it is a definition that will be adopted by

[6] https://www.oecd-ilibrary.org/taxation/tax-challenges-arising-from-the-digitalisation-of-the-economy-commentary-to-the-global-anti-base-erosion-model-rules-pillar-two-first-edition_1e0e9cd8-en

all countries implementing Pillar Two in the near future, including Australia[7]. Reference should also be made to any unilateral minimum tax a country adopts outside of Pillar Two. To ease compliance, countries or regimes that are not considered as having a minimum tax of 15% or more could be prescribed by regulation similar to the process that applies to the CFC rules.

We also suggest that only taxes that apply to income that is in scope be considered. Any applicable withholding tax should also be factored in.

- **Ministerial determination based on the country having a preferential patent box regime** - We consider that it is sufficient for Australia to rely on the OECD Forum on Harmful Tax Practices (i.e. the publications noted in paragraph 1.64 of the EM) to determine whether a country has a preferential patent box regime without sufficient economic substance. There is no need for Australia to go out on its own and have a separate Ministerial determination for 'harmful' patent box regimes.

  This would not be a beneficial or, arguably, an appropriate use of limited Ministerial time and resources. Indeed, what criteria would Australia use to make its own determination that the OECD has not already considered? The relevant OECD team that has already undertaken this exercise has the relevant subject matter expertise to do this review.

  Further, it is unclear why the deduction should be denied to a taxpayer simply because of the existence of a patent box regime if it has not availed itself of the benefits of the regime.

2. Breadth of application of Section 26-110

The proposed section 26-110 is drafted extremely broadly and will likely result in legitimate commercial transactions being subject to the rules and deductions unnecessarily denied. We have identified a number of problems with the proposed provision:

- **Double taxation** - The lack of any anti-overlap type of rule that creates a safe harbour for instances where the intangible asset receipt is subject to Australian tax under the CFC rules is not an equitable outcome. Contrast this outcome to that under published ATO guidance for offshore arrangements perceived to put Australian revenue at risk, such as marketing hubs under PCG 2017/1[8] (see in particular at paras 163-166). The 'green zone' under such arrangements expressly includes the situation where the income of the marketing hub is subject to CFC attribution. This achieves a neutral, non-discriminatory outcome for the Australian taxpayer.

- **Associate** - The use of the term 'associate' as defined in section 318 of the *Income Tax Assessment Act 1936* (Cth) (**1936 Act**) is a very broad term. It is unclear how this would work in practice. Would taxpayers be required to demonstrate that rights to

[7] Though, a qualification to this is that Pillar Two has not yet been formally adopted by Australia.
[8] Practical Compliance Guideline PCG 2017/1 ATO compliance approach to transfer pricing issues related to centralised operating models involving procurement, marketing, sales and distribution functions

exploit an intangible asset are not granted to an associate? How will the ATO administer this?

It may be more sensible for the provision to be concerned with transactions between related parties. Related parties have a closer relationship to the SGE than an associate of the SGE does. The use of the 'related parties' concept is better aligned to the OECD concepts impacting SGEs rather than the domestic concept of 'associate' which is unique to Australia. The same interpretation of related parties provided by the ATO for the purpose of the transfer pricing rules should also apply in this context[9].

- **Embedded royalties** – Subsection 26-110(2) attempts to capture payments 'to the extent' they are attributable to a right to exploit an intangible asset, that is payments part of which is comprised of an 'embedded royalty' or payment referrable to an intangible. It is unclear in practice how this provision would apply and how this test in fact differs from existing transfer pricing analysis.

  Existing transfer pricing provisions require consideration of whether cross-border related party payments made by Australian resident taxpayers contain a royalty element. The fact that a royalty may be paid further up the chain does not necessarily mean that payments made by Australian resident taxpayers contain either a royalty or embedded royalty component. If Australian transfer pricing principles determine that no element of an outbound payment for goods or services should be characterised as a royalty, it is anomalous to suggest that Australia should now be able to deny a deduction for some or all of the outbound payment. The tax treatment of payments further up the chain is a matter for the jurisdictions in which the relevant foreign companies are tax residents. If those jurisdictions determine that transactions between the foreign companies have been characterised and priced correctly in accordance with the relevant foreign tax and transfer pricing provisions, then there should be no policy basis for Australia to now seek to deny deductions for any outbound payments.

  Where there is no open market for the relevant related party transactions, there are significant practical difficulties in apportioning and valuing embedded intangibles in arrangements (including service contracts). The apportionment is made even more challenging by the broad drafting. Accordingly, clearer parameters are required to provide clarity in the following areas to avoid ambiguity in applying the new rules.

- **Tracing of funds** – Subparagraph 26-110(2)(c) provides that the income can be derived either directly or indirectly from the exploitation of the intangible and subparagraph 26-110(3)(a) provides that it does not matter whether the payment is made to the recipient directly or through one or more other entities. When read together, they imply strict tracing of the funds paid to the income derived is not required. Paragraph 1.34 of the EM confirms this, noting "[w]here income is derived indirectly, strict tracing through the flow of funds is not required, in particular, it is not necessary to demonstrate that each payment in a series of payments funds the next payment or is made one after the other. Rather, it is sufficient if the payment exists between each entity."

[9] See for example the interpretation of 'international related parties' at paragraph 84 in Practical Compliance Guideline PCG 2017/2 Simplified Transfer Pricing record-keeping options.

Again, any connection between the payment made and income derived associated with the exploitation of the intangible will trigger the application of the rules even if the payment is calculated on arm's length terms. This is too broad. More should be required than simply saying that Australia makes a payment to Company A which pays to Company B, therefore the payment to Company B is related to the payment from Australia. A closer connection between the payment and income derived should be required where the payment can be directly traced to the income derived.

- 'Intangible assets' definition – A specific definition is given for the term 'intangible assets' for the purpose of section 26-110 only (subsection 26-110(8)). It is defined in subsections 26-110(5) – (7) by reference to some parts of the definition of 'royalty' in section 6(1) of the 1936 Act. Certain rights and interests are excluded. By extension, any property or right that is not tangible and is not covered by the specific exclusions would appear intended to be included as a form of intangible asset. This is a complicated way to define the term and has raised questions around whether certain items such as mining rights, carbon units (e.g. Australian Carbon Credit Units[10]) and even shares are included or excluded. This creates unnecessary uncertainty for taxpayers.

  A definition that is more closely aligned with the OECD definition would be a better approach to avoid the arising of double taxation that disadvantages Australian companies. Furthermore, the scope should be limited to highly mobile intangibles deliberately moved in contrast to its DEMPE[11] functional analysis to avoid unintended impact on genuine business/commercial arrangements (for example, services contracts where the use of embedded software is an incidental part of the services provided should not be caught by this proposed rule).

- Meaning of 'exploit' - As currently drafted in subsection 26-110(9), to 'exploit' an intangible asset includes "doing anything else in respect of the intangible asset" which could extend the scope of these provisions beyond the commercial understanding of exploitation and any reasonable or practical basis for establishing its limits.

  The combined effect of the extended definition of 'intangible asset' which includes commercial information as defined in subsection (c) of the definition of 'Royalty' in section 6(1) of the 1936 Act (being the supply of scientific, technical, industrial or commercial knowledge or information), together with the very broad definition of exploit (which only requires the foreign associate to exploit, use or do anything in respect of the commercial information), creates uncertainty about whether **any** payment by an Australian resident to a foreign associate will be deductible (except where it is for something covered by the exemption to the definition of intangible asset, or the foreign resident is not in a 'low corporate tax jurisdiction').

  While the definition of 'exploit' may require some degree of broad drafting given the intention of the integrity measures, it cannot be so broad as to go beyond any realistic commercial arrangement or understanding. For example, theoretical

[10] The Australian tax treatment of Australian Carbon Credit Units (**ACCU**) under Division 420 of the 1997 Act is unclear in its interaction with the new section 26-110. Section 420-65 says in working out what you can deduct you must disregard any other deduction provision of the Act, but section 26-110 is about what you cannot deduct (not what you can deduct). Presumably, it can treat as non-deductible a payment to an associate for an ACCU circumventing section 420-65.

[11] DEMPE stands for Development, Enhancement, Maintenance, Protection and Exploitation.

'permission' (per subsection 26-110(10)) or common understanding that does not amount to a legal/economic right should not be covered as there is no commercial value to these understandings – such arrangements should be excluded to avoid disproportionate compliance costs to taxpayers.

Similarly, product marketing services provided by an agent may not ordinarily involve the passing of valuable commercial knowledge to the principal, so the mere provision of a sales contract for execution, or even the occasional advice on what products are expected to be most saleable, could fall within the uncertain scope of these provisions.

- **Applying the 'low corporate tax jurisdiction' definition relies on there being an SGE** – The operation of subsection 26-110(11) appears to turn on the lowest corporate income tax rate under the laws of the foreign country that apply to an SGE. This provision assumes that the same definition of SGE used in Australia is the same in every other country. More than likely, this is not the case.

  It appears the provision is trying only to consider the tax laws of the foreign country that apply to the income of an SGE. Perhaps it would be more sensible if the provision were amended to refer to tax laws that apply to the income of an entity that is **equivalent** (in size and turnover) to an SGE. This would make the provision more workable.

3. Other issues

a) Application of section 26-110 to branches and permanent establishments (PE)

The legislation should make clear how proposed section 26-110 would apply to Branches/PE vs subsidiaries. In relation to branches/PE, since the ownership of the intangible remains with the same legal entity, the relevant payment/credit between the branches/PE is a matter of cost allocation/branch attribution (not a deduction) and therefore the proposed section 26-110 should not apply.

b) Consideration of a shortfall penalty

Paragraph 1.40 of the EM states that a shortfall penalty is being considered to penalise SGEs who mischaracterise payments to avoid income and withholding tax. We consider this penalty to be unnecessary as SGEs are already being sufficiently penalised by losing the deduction for a payment caught up in these rules. Other penalties which apply to SGEs under Part IVA would likely apply in the most egregious cases. No additional penalty is necessary.

c) Payments subject to withholding tax

Double tax could arise where a deduction is denied for a payment upon which withholding tax is also borne. Where a deduction is denied, withholding tax should not apply, particularly where payments are made to an entity that is not in a low tax jurisdiction. Also, no Mutual Agreement Procedure relief would be available either.

d) No exclusion for payments made to parent jurisdictions

No exclusion has been provided for payments ultimately received in the same jurisdiction in which the ultimate parent is located. This is inconsistent with other integrity measures, such as the financing integrity rule in Subdivision 832-J in the Hybrid mismatch rules. It is also inconsistent with the ATO's published position in PCG 2017/4[12] where consideration is given to where the ultimate parent is the lender or a subsidiary taxed in the parent's jurisdiction in determining the 'risk' regarding the related party financing.

To be consistent with the hybrid rules and the position in PCG 2017/4, an exclusion should be provided for payments ultimately received in the same jurisdiction in which the ultimate parent is located.

e) Interaction with the CFC rules

As noted above, income may be included in an SGE's assessable income under section 456 of the 1936 Act (with a foreign income tax offset for foreign tax paid) but no deduction for the payment is permitted. This results in an asymmetrical outcome for an arrangement where there can be no suggestion of tax avoidance because the income earned by the foreign associate was subject to tax at an overall tax rate of 30%. This is an inequitable outcome.

f) Taxpayers that have an Advance Pricing Arrangement (APA)

Clarification is needed on how these rules are intended to apply to a taxpayer that has an APA. Do these rules override the APA? It would be an extraordinarily unjust outcome for taxpayers with an APA for it to be overridden by these proposed rules.

g) Examples in the EM

The EM only contains one simple example to demonstrate how the proposed rules would apply. It is always useful for an EM to include multiple examples demonstrating how legislation is intended to apply. In this scenario, this would include:

- An example of where a payment is made for the use of the intangible on arm's length terms.
- Examples of how payments are to be apportioned to the extent of any embedded royalty.

h) Requirement for ATO guidance

Given the breadth of the proposed rule and the inherent uncertainty of how the ATO may administer the proposed rules, it is imperative the ATO issue timely, practical guidance to accompany the draft rules, including rules on tracing.

[12] Practical Compliance Guideline PCG 2017/4 ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions

4. Suggested solution – a two-pronged 'purpose' and 'principal effect' test

We suggest to better target the proposed rule the provisions should be expressed as a 'purpose' test (such as a 'dominant purpose' or 'principal purpose') or substance based carve-out similar to other integrity measures **and** principal effect test to capture arrangements involving payments for the exploitation of intangibles where the payment can be strictly traced to income derived in a low corporate tax jurisdiction.

The 'purpose' test could be deemed to be satisfied if the income side of the transaction is subject to Australian income tax.

The second limb 'principal effect' test could be calculated by reference to the 'Covered Taxes' defined for Pillar Two purposes to ensure consistency with the future development on Pillar Two rules and minimise the chance of overlap.

The definition of low corporate tax jurisdiction would also need to be reviewed per our comments under Part 1 above.

A rule expressed in this way would be specifically targeted to perceived mischief and be more aligned with Australia's commitment to the Inclusive Framework global solution.

5. Sunsetting

Given the proposed rule is effectively equivalent to the undertaxed profit rule in Pillar Two, it should as a minimum sunset when the Pillar Two solution commences operation in Australia. In the meantime, it should also not apply to countries that have adopted the Pillar Two solution in their domestic tax laws.