Law Council
OF AUSTRALIA

Business Law Section

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By email: MNETaxIntegrity@treasury.gov.au

Dear Ms Ram

Multinational tax integrity – denying deductions for payments relating to intangible assets connected with low corporate tax jurisdictions

1. This submission is made by the Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**) in response to the exposure draft legislation for the Treasury Laws Amendment (Measures for Consultation) Bill 2023: Deductions for payments relating to intangible assets connected with low corporate tax jurisdictions' (**Exposure Draft**) and the Exposure Draft explanatory materials (**EM**) (together the **Measure**).

2. Reference is made to the previous submission of the Law Council dated 9 September 2022 which dealt with the Treasury consultation paper entitled "Government election commitments: Multinational tax integrity and enhanced tax transparency" (**Previous Submission**).

3. Legislative references are to the *Income Tax Assessment Act 1997* (**1997 Act**), *Income Tax Assessment Act 1936* (**1936 Act**), and the *Taxation Administration Act 1953* (**TAA**), as appropriate.

Key Points

4. The key matters the Committee wishes to bring to Treasury's attention are as follows:

   Clarification of matters to which the Measure should not apply

   (a) It is submitted that the Measure should not apply where:

      (i) the taxpayer shows the form adopted is consistent with dealings between unrelated parties;

      (ii) there is no tax avoidance behaviour, either by applying a purpose rule present in the multinational anti-avoidance law (**MAAL**) and diverted

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profits tax (**DPT**) or applying the sufficient economic substance test which is present in both the DPT and is featured in the Measure in relation to patent boxes, or both; and

(iii) the payment is characterised by the Australian payer as a royalty for Australian tax purposes, and royalty withholding tax is collected and remitted.

Interrelationship with other Pillar 2 measures:

(b) It is submitted that the Measure is in the nature of a Pillar 2 Under Taxed Payment Rule (**UTPR**), and should incorporate elements to make it consistent with Pillar 2):

(i) The Measure should calculate a jurisdiction's "corporate income tax" for the purposes of subdivision 960-L as

1. including any Income Inclusion Rule (**IIR**) paid in relation to the jurisdiction;

2. including any Qualified Domestic Minimum Tax (**QDMTT**) in the jurisdiction;

3. an "effective tax rate" in the manner required under the Pillar 2 model rules.

(ii) The Measure should calculate any non-deductible amount so that the effective tax rate on the attributable amount received by the low tax jurisdictions suffers an effective tax rate, after considering the impact of non-deductibility, of 15 per cent.

(iii) The commencement date should be timed to coincide with the adoption by Australia of the remainder of the Pillar 2 model rules.

Need for practical guidance

(c) As the proposed anti-avoidance rule introduces several concepts that have broad application, additional commentary and examples should be inserted in the explanatory materials that are directed towards certain issues that are likely to cause the most uncertainty.

(d) Without limitation, the following four areas would benefit from further commentary and the inclusion of appropriately drafted examples:

(i) the current definition of "exploit" which currently gives rise to excessive uncertainty;

(ii) the concept of "finished goods" which currently requires more principled guidance;

(iii) illustrating how and when apportionment will likely arise in practice; and

(iv) illustrating how a "low corporate tax jurisdiction" is to be determined under the Measure.

The proposed shortfall penalty

(e) The Committee is unclear as to what set of facts constitute a significant global entity (**SGE**) which "mischaracterises a payment made". The word has application where a description of a set of facts does not correctly describe them. The Committee believe the provisions of the Tax legislation relating to "false or misleading statements" already apply to such situations. It is not clear what deficiency is said to exist in those provisions.

Submissions

1. Clarification of matters to which the Measure does not apply

5. The proposed anti-avoidance rule adopts particular conditions for its application, consistent with the Previous Submission, in particular that the Measure should only apply:

   (a) to SGEs;

   (b) to a small range of payee countries namely those below a 15 per cent tax rate; and

   (c) to dealings between associates.

6. Those conditions are appropriate, albeit the Committee comments below further on the application of the 15 per cent tax rate and its interrelationship with Pillar 2 measures.

7. In the Previous Submission, the Committee also suggested that:

   (a) there were already a range of integrity rules that could apply to deal with the relevant issue. Reference was made to:

      (i) Transfer pricing rules, including the reconstruction rules in section 815-130 of the ITAA 1997;

      (ii) Part IVA, including the DPT and the application of the General Anti-Avoidance Rule to schemes to avoid withholding tax;

      (iii) Principal purpose tests present in Australia's double tax treaties.

      Accordingly, it was submitted any new rule must be directed to conduct which is not adequately addressed by existing rules.

   (b) defences should be available where there is sufficient economic substance;

   (c) any new rule must also address the interactions with Australia's withholding tax system. Royalties paid to recipients in countries which do not have a tax treaty with Australia are currently subject to 30 per cent withholding tax, and accordingly cannot have a base eroding effect. The Committee noted that to the extent that the Measure applies to royalties, it would appear that it could only apply in transactions with tax treaty partners (which may not be consistent with the intent of the tax treaties, and may lead to retaliatory actions).

8. Dealing with these matters further, it is noted that focus of the rule appears to be SGEs which mischaracterise payments that are in substance, but not legal form, made for the right or permission to exploit an intangible asset (Exposure Draft EM at [1.11]). The mischaracterisation is said to result in royalty withholding tax not being paid (at [1.13]). That is said to lead to insufficient tax being paid, by structuring arrangements to ensure that income from exploiting intangible assets is derived in jurisdictions that deliver the most tax effective outcomes (at [1.16]).

9. It is suggested that Australia already has rules which deal with this issue. The principal remedy lies in Australia's transfer pricing rules (and double tax treaty equivalents). Those rules apply an arm's length test to dealings between associates, and allow non arm's length dealings to be recharacterised, including that form can be disregarded if that is inconsistent with the substance of the relevant commercial and financial relations, and allows arm's length commercial and financial relations to be substituted for the actual commercial and financial relations which the associated entities adopted.

10. Further rules lie in Part IVA. Traditionally, the focus of Part IVA in its general anti-avoidance rule has been on schemes to avoid Australian tax. However, in introducing the MAAL and the DPT, focus has been added to apply the purpose test at a lower threshold (principal rather than dominant) and to foreign as well as Australian tax benefits. A key defence to the application of the DPT is that it will not apply if the sufficient economic substance test is satisfied (see s 177M of the ITAA 1997).

11. The EM suggests at [1.47]:

> "It is not intended for this anti-avoidance rule to inappropriately apply to genuine supply and distribution arrangements between associates, <u>where there is no tax avoidance behaviour</u>. For example, trademarks printed on finished goods that are marketed and sold by an SGE to customers, without payments to an associate being mischaracterised or being effectively for the use of that trademark in the SGE's business beyond the mere marketing and selling of those finished goods, <u>would be unlikely to attract the operation of this anti-avoidance rule</u>. To ensure these arrangements are not inappropriately caught, the provisions preclude the section from applying in relation to an intangible asset that is a right in respect of, or an interest in:
>
> • a tangible asset; or
>
> • an intangible asset to which the section does not apply and the payment relates to the tangible good or other excluded asset.
>
> **[Schedule xx, item 2, paragraphs 26-110(1) and (7)(a) and (d) of the ITAA 1997]**
>
> <u>(emphasis added)</u>

12. It is not apparent what the "tax avoidance behaviour" would be. That conduct "would be unlikely" to be caught suggests a need for greater clarification, and in that regard, below the Committee suggests that there is a need for greater practical guidance to be given in the relevant materials (see below at [24]-[37]).

13. However, the Committee also suggests that there should be defences in the following cases:

(a) where the taxpayer shows the form adopted is consistent with dealings between unrelated parties – thereby not prejudicing those entities who are parts of multinational groups rather than those entities which deal with unrelated parties;

(b) where there is no tax avoidance behaviour, either by applying the purpose rule present in the MAAL and DPT or applying the sufficient economic substance test which is present in both the DPT and is featured in the Measure in relation to patent boxes, or both. It is suggested the current terms of the Measure give no rule to apply to distinguish conduct which should fall outside its purpose. The recognition of the sufficient economic substance rule in relation to patent boxes should be applied throughout the amendment.

14. Finally, it appears that the Measure is directed principally to associated dealings which mischaracterise intangible transactions that give rise to payments which should be royalties. The Measure suggests that it would apply on an apportionment basis, that is, to the extent the payment is attributable to the right to exploit the intangible asset.

15. Accordingly, it is suggested that the Measure should not apply if the payment is characterised by the Australian payer as a royalty for Australian tax purposes, and royalty withholding tax collected and remitted. The contention that in such cases the payment has been "mischaracterised" would be inappropriate.

2. Interrelationship with other Pillar 2 measures

16. The Committee is concerned that there are a number of features of the Measure that, if unchanged, may be seen as inconsistent with the intent of the Pillar 2 measures that Australia has committed to support.

17. In particular, the Committee believes the Measure is clearly an **UTPR** as contemplated by the Pillar 2 proposals. The Committee believes such measures are intended only as part of a comprehensive package of Pillar 2 measures. Further, they are intended as a provision of last resort (or as the OECD refers to it, "a backstop").

18. It is then critical that the Measure complies with the design features set out in Pillar 2. This Measure does not address the other aspects of the Pillar 2 proposals.

(a) The Committee believes that to be consistent with Pillar 2 it should at least recognise that that some jurisdictions will impose a QDMTT, which does not form part of the jurisdiction's 'headline" corporate tax rate, but actually completely ensures the actual headline corporate tax rate will meet the minimum rate of 15 per cent.

(b) The Committee also notes that the Pillar 2 Model Rules operate on the basis of "effective tax rate" as defined, not headline rate. Consistency with the design of Pillar 2 would lead to replacement of "headline tax" with "effective tax" rate as set out in Chapter 5 of the Model rules, and integration of the Measure into the full Pillar 2 Model Rules.

(c) The Committee also believes an UTPR is inappropriate in any event when (even if there is no local QDMTT), the profits are subject to tax in the head office jurisdiction under an IIR, including where an active income exclusion or other agreed safe harbours are applied in accordance with the Pillar 2 proposals. This is because the IIR ensures the profits have been effectively taxed at the minimum rate of 15 per cent.

(d) The Committee also believes it is inappropriate for Australia to levy both withholding tax and apply a UTPR like provision. The impact is otherwise an effective tax rate significantly above the OECD minimum target of 15 per cent. Further, it is an impact which exceeds what the OECD refers to as "an amount sufficient to result in the group entities paying their share of the top-up tax remaining after the IIR".

(e) The Committee believes the Measure should be deferred until the majority of jurisdictions have implemented Pillar 2 legislation packages, because otherwise Australia will be penalising groups for legislative delays by other nations.

19. The policy intent of Pillar 2 is to ensure multinational groups pay a minimum of 15 per cent tax on profits in each jurisdiction. This policy is achieved by several interrelated proposals. Importantly, the measures are intended to operate as a "package".

20. The first, and key, element of Pillar 2 is contained in Chapters 2-5 of the Model Rules, and involves a calculation of Effective Tax Rate in each jurisdiction the group operates in. These calculations are essentially conducted on accounting profit, after certain adjustments. The rules then provide for calculation of an amount of "top up tax" to bring the effective tax rate in each jurisdiction to the minimum rate of 15 per cent. There is a "substance-based income exclusion". The result is an ability of the parent jurisdiction to ensure underlying profits are taxed at the target rate of 15 per cent, subject to substance-based exclusions and safe harbours. This is the IIR. But the calculation is done at 'effective tax rate" (Chapter 5 of the Model Rules), not headline rate. The Committee believes that, since the entire focus of the rules is "effective rate", an Australian measure that references "headline rate" is inconsistent with, and potentially leads to outcomes unintended by, the rules.

21. The source jurisdictions retain the right to impose a domestic minimum top-up tax, which is then fully creditable against any calculation of IIR. This is the QDMTT.

22. It is intended that a paying jurisdiction would have an ability to deny deductions in a manner consistent with the objective of ensuring an effective minimum tax rate in foreign entities of 15 per cent. This is the UTPR (Chapter 2, Model Rules). Its operation is integrated with that of the IIR.

23. The complexity of a compliant UTPR proposal is acknowledged by the OECD which says:

> *"The same calculations under Chapter 5 are applied whether the top-up tax is being charged under the IIR or the UTPR, to ensure co-ordinated outcomes. However, given that there will typically be subsidiaries in several different jurisdictions, the UTPR requires a higher level of administrative co-operation, which underlines the importance of the standardised information reporting requirements*

3. Need for practical guidance

<u>The proposed measures contain a number of broad concepts</u>

24. The proposed anti-avoidance rule introduces several concepts that have broad application, including what an "intangible asset" is determined to be, what is

considered (and not considered) to be "exploitation" and whether a jurisdiction is in fact a "low corporate tax jurisdiction".

25. It is apparent these concepts have been deliberately designed to apply broadly and to a wide range of circumstances. However, because of this, there is a significant degree of uncertainty regarding whether the rules apply to a business's specific circumstances and if so, how they are intended to apply in practice. In turn, this may lead to increased tax controversy and disputes in an area of tax law that is already complex.

Additional commentary and examples in explanatory materials

26. Notwithstanding the Committee's submissions above that the Measure be amended to reduce uncertainty, it would be useful in any event for additional commentary and examples to be inserted in the explanatory materials that are directed towards certain issues that are likely to cause the most uncertainty. Notably, the EM currently includes only one detailed example: see Example 1.1 at paragraph 1.32.

27. Without limitation, the Committee suggests that the following four areas would benefit from further commentary and the inclusion of appropriately drafted examples:

    (a) first, the current definition of "**exploit**" which gives rise to excessive uncertainty;

    (b) secondly, the concept of "**finished goods**" which requires more principled guidance;

    (c) thirdly, illustrating how and when **apportionment** will likely arise in practice; and

    (d) fourthly, illustrating how a "**low corporate tax jurisdiction**" is to be determined under the proposed Measure.

28. In relation to the first issue, the proposed legislation currently defines "exploit" as including to "*do anything else* in respect of the intangible asset".[1] A literal interpretation of the text indicates an unlimited scope.

29. As such, it is important to provide additional commentary or examples of activities that will *not* fall within the meaning of the term "exploit". Paragraph 1.52 of the EM sets out a range of positive examples of activities that are considered to fall within the meaning, but there are currently no negative examples (i.e. what activities would not constitute exploiting an intangible asset). Having regard to the second issue outlined below, negative examples not involving finished goods would be particularly helpful.

30. In relation to the second issue, paragraph 1.47 of the EM refers to "trademarks printed on finished goods that are marketed and sold by an SGE to customers" and that "the mere marketing and selling of those finished goods, would be unlikely to attract the operation of this anti-avoidance rule".

31. Additional commentary or examples should be provided that set out the *reason* for why an intangible asset constitutes part of a "finished good". For example:

    (a) The ATO's TA 2018/2 *Mischaracterisation of activities or payments in connection with intangible assets*, alludes to an incidental/ancillary concept

[1] Exposure Draft s 26-110(9)(e) (emphasis added).

when it refers to (emphasis added): "resellers of finished tangible goods where the activity of reselling the goods involves an incidental use of a brand name that appears on the goods and related packaging".

(b) The ATO's draft TR 2021/D4 *Income tax: royalties – character of receipts in respect of software* includes an example concerning simple use of software (see Example 2).

32. If "incidental use" or "simple use" cases are indeed the policy outcome sought, such reasoning should be included in the EM, if not the legislation itself. This will assist taxpayers in understanding the difference between an appropriate and an inappropriate payment.

33. In relation to the third issue, the principle of apportionment should be supported by additional commentary and/or further practical examples. Paragraph 1.38 of the EM recognises that "a deduction that is denied for a payment attributable to the right to exploit an intangible asset may be apportioned … to the extent that the payment is attributable to the right to exploit the intangible asset". Especially in circumstances where the parties have agreed, sometimes at arm's length, that the payment is not attributable to any exploitation, detailed commentary and/or examples on whether and how apportionment should be performed would be useful.

34. Given the complexity of apportionment in tax matters generally, an example should at least be provided to illustrate where the issue may arise in practice. In this respect the Committee notes:

(a) the ATO's draft TR 2021/D4 *Income tax: royalties – character of receipts in respect of software* already included an example concerning apportionment that could be used for these purposes (see Example 4).

(b) The Committee's previous submission in response to the Consultation Paper also outlined a common example that could be adapted for these purposes (at [90]):

> *[The] issue can be illustrated by the simple example of the importation and distribution of branded goods where the distributor pays amounts to the offshore owner of the goods and brand. … The distribution agreement may provide for [1] the distributor to buy the goods from the owner and [2] may provide the distributor with a royalty free licence to use the brand as part of its distribution activities. Classically, those payments would be seen as the purchase price of the goods, with no identifiable royalty being paid. Alternatively, the parties could elect for the distributor to pay a lower amount for the goods acquired, and a separate amount for the use of the IP locally, in which case those latter amounts would be royalties.*

35. In relation to the fourth issue, additional commentary or examples should be included that step out the analysis required for a low corporate tax jurisdiction. An example could make clear that a jurisdiction can have a headline corporate tax rate of over 15 per cent but still be defined as a "low corporate tax jurisdiction" due to the proposed statutory modifications. In that vein, examples applying those modifications would assist in providing clarity to readers.

Additional public advice and guidance (**PAG**) should be developed and promptly released by the ATO

36. In addition, the Committee encourages Treasury and the ATO to ensure that any relevant existing PAG is revised promptly, and that new PAG be issued as soon as practicably possible addressing any areas of potential uncertainty and risk.

37. The Committee recognises that the ATO plays a valuable role in providing contemporary administrative guidance to taxpayers. In this respect, the Committee encourages Treasury and the ATO to work together in applying the New Law Guidance Review recommendations.[2]

Conclusion and further contact

38. The Committee would be pleased to discuss any aspect of this submission.

39. Please contact the chair of the Committee, Justin Byrne, at justin.byrne@qldbar.asn.au if you would like to do so.

Yours faithfully

Philip Argy
Chairman
Business Law Section

[2] See ATO and Commonwealth Treasury, *Review of process for supporting new tax laws with extrinsic materials and ATO guidance* <https://www.ato.gov.au/law/view/document?docid=SGM/NLG>.