

# **Multinational Tax Integrity – denying deductions for payments relating to intangible assets connected with low corporate tax jurisdictions**

**KPMG submission**

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# Executive summary

As a leading professional services firm, KPMG Australia (**KPMG**) is committed to meeting the requirements of all our stakeholders – not only the organisations we audit and advise, but also employees, governments, regulators and the wider community. We welcome the opportunity to provide a submission on the exposure draft *Treasury Laws Amendment (Measures for Consultation) Bill 2023: Deductions for payments relating to intangible assets connected with low corporate tax jurisdictions* released by Treasury on 31 March 2023.

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In its current form the intangibles measure will create double taxation outcomes and departs from internationally agreed principles. The measure should be narrowed to focus on genuinely low taxed payments with a tax avoidance purpose.

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KPMG supports the Federal Government's commitment to maintaining the integrity of Australia's tax base and its intention to deter tax avoidance behaviours. However, we have concerns as to the current form of the intangibles measure. In its current form it asserts primary taxing rights over offshore low-taxed income and operates outside the BEPS 2.0 globally agreed framework. The measure also creates clear double tax outcomes which need to be addressed to ensure it applies in an equitable manner.

Given the Federal Government's strong support of BEPS 2.0, we expect it would be challenging to explain to the OECD and Inclusive Framework members why Australia would introduce a measure that operates outside the internationally agreed framework.

KPMG's submission recommends a carve-out for multinational groups that are subject to Pillar Two. Alternatively, Pillar Two top-up taxes should be accounted for in the determination of 'low corporate tax jurisdiction'.

In addition, the absence of a principal purpose test or economic substance exception will unfairly impact arrangements where there is no tax avoidance motive or artificial structuring.

KPMG looks forward to continued engagement with the Federal Government as it implements these rules.

Yours sincerely,

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# Background

## About KPMG

KPMG is a global organisation of independent professional firms, providing a full range of services to organisations across a wide range of industries, governments and not-for-profit sectors. We operate in 146 countries and territories and have more than 227,000 people working in member firms around the world. In Australia, KPMG has a long tradition of professionalism and integrity combined with our dynamic approach to advising clients in a digital-driven world.

## KPMG International Tax practice

KPMG's International Tax practice works with multinational organisations to provide commercially focused advice on cross-border tax matters. We help companies manage the complexities of meeting their tax obligations relating to multiple tax systems and supranational regulation around the world.

We partner with our clients to advise on and manage the tax implications relating to their cross-border arrangements, structures and transactions. We also help businesses manage the tax impact and drive efficiency relating to complex events, including cross-border mergers and acquisitions, divestments, international expansion, cross-border financing, and business change. By drawing not only on our network of tax professionals around the world, but also on our specialists in other areas of taxation, we provide a complete, multi-disciplined perspective to any tax challenge.

# **Section 1:**

# **KPMG recommendations**

## RECOMMENDATION 1:

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As a member of the Inclusive Framework on BEPS, Australia has made commitments in relation to the taxation of low-taxed income of large multinational groups. The intangibles measure operates outside the Pillar Two internationally agreed framework, and it is highly likely that this will result in the government being viewed internationally as unilaterally departing from its BEPS 2.0 commitments.

It is therefore necessary for the intangibles measure to recognise and give priority to the application of Pillar Two and address double tax outcomes. We strongly recommend an approach which carves out multinational enterprises or jurisdictions that are subject to Pillar Two or a domestic minimum tax. Alternatively, Pillar Two and domestic minimum top-up taxes must be accounted for in the determination of a low corporate tax jurisdiction.

## RECOMMENDATION 2:

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Given the intention is for the intangibles measure to target multinational groups who avoid income tax through the structuring of their arrangements, we strongly recommend that the rules include a principal purpose test or economic substance exception. If not, the rules will unfairly impact groups in situations where there are bona fide arrangements with no BEPS motives.

Under the proposed drafting, a global group headquartered in a low tax jurisdiction will be denied deductions, even where the business was founded in that jurisdiction and the group's intangibles have been developed and continually held in that jurisdiction. In such cases, there is no tax avoidance motive or shifting of intangibles for tax purposes. As such, where a principal purpose test or economic substance exception is not included in the intangibles measure, the measure should include a specific carve-out where the intangible is located in the parent company jurisdiction (similar to Australia's hybrid mismatch financing integrity rule).

## RECOMMENDATION 3:

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The drafting of the low corporate tax jurisdiction test should be reconsidered as it does not achieve its intention as a 'headline' tax rate test and its operation is unclear. It applies on a per country basis regardless of the tax profile of the relevant foreign entity, which means every taxpayer will need to make an individual assessment of the status of each foreign country. Many jurisdictions have different rates of income tax and exemptions for certain types of income, and under one interpretation of the proposed drafting all of these jurisdictions (where this results in a rate of tax below 15 percent for a single type of income) would be deemed to be low corporate tax jurisdictions, even where they have high headline rates of tax that apply to all or the majority of an entity's income in that jurisdiction.

Further, any definition of a corporate income tax should include state and municipal taxes which operate effectively as national corporate taxes, as otherwise this unfairly prejudices countries that allow corporate tax to be imposed at multiple government levels.

To provide certainty, a list of foreign jurisdictions in the scope of these rules should be published and maintained.

## RECOMMENDATION 4:

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The exploiting intangible assets test should be restricted so that routine activities not connected with a global group's core set of intangibles do not fall within the scope of this measure. Under the proposed drafting, even access by Australian personnel to the global intranet site of a multinational group could be in-scope.

## RECOMMENDATION 5:

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To address inequities, the rules should be updated to allow for a pro-rata denial of an otherwise in-scope payment taking into account the extent to which income is subject to 'low tax'. A deduction should only be denied to the extent the tax rate in the low corporate tax jurisdiction applicable to that income is below 15 percent (e.g. jurisdictions with headline rates of just below 15 percent should be not treated in the

same way as jurisdictions with no corporate tax). A deduction should also only be partially denied to the extent the income is ultimately derived in a low corporate tax jurisdiction.

#### RECOMMENDATION 6:

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Recognition of Australian withholding tax is necessary to ensure no double tax outcomes. Under proposed drafting, a royalty paid to a non-resident that is subject to Australian withholding tax (e.g. at a rate of 30 percent for residents of non-treaty countries) can still be denied a deduction for the royalty payment.

#### RECOMMENDATION 7:

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Many of the concerns raised above (and throughout our submission) could be addressed by adopting the legislative design of the hybrid mismatch financing integrity rule, supplemented by an explicit carve-out for multinational enterprises subject to Pillar Two.

# **Section 2:**

## **KPMG insights**



# Response to consultation

## Pillar Two interactions

Addressing low-taxed income in a multinational group is the specific focus of the Pillar Two common approach. Under the Pillar Two<sup>1</sup> Global Anti-Base Erosion (**GloBE**) rules, Australia is committed to the following principles in respect of an offshore low-taxed entity:

- The primary taxing right for any top-up tax sits with either the low-taxed entity's jurisdiction of residence (through a Qualifying Domestic Minimum Top-up Tax (**QDMTT**)), or with the jurisdiction of residence of its ultimate parent entity (through an Income Inclusion Rule (**IIR**)); and
- Where top-up tax is not paid through a QDMTT or IIR, secondary taxing rights to apply top-up tax to the profits of any offshore low-taxed entities (through a denial of a deduction or additional tax) is given to participating jurisdictions through the backstop Undertaxed Payments Rule (**UTPR**).

Under the intangibles measure, Australia would be effectively asserting primary taxing rights in respect of an offshore entity's low taxed income, rather than a residual right. In fact, it is more acute as the loss of deductions does not count towards a 'covered tax' that would otherwise reduce potential Pillar Two top-up tax.

Given the proposed drafting disregards any top-up tax, the measure applies tax on the same profits, resulting in double tax outcomes. A multinational enterprise (**MNE**) group could be subject to top-up tax under a QDMTT or IIR to achieve a GloBE effective tax rate of 15 percent in respect of a payment from Australia to a low-taxed entity, but the group would then be denied the tax deduction for the same payment at the 30 percent Australian income tax rate.

The Federal Government has expressed strong support of BEPS 2.0, and as such we expect it would be challenging to explain to the OECD and Inclusive Framework members why Australia

would introduce a measure that operates outside the internationally agreed framework.

The GloBE rules would ensure a MNE's operations in a particular jurisdiction are subject to a minimum 15 percent effective tax rate. Hence, that jurisdiction should not be considered a low-tax jurisdiction and it would not be necessary to deter tax avoidance behaviour through the intangibles measure.

The intangibles measure must not ignore Pillar Two and it is critical that changes are made to appropriately recognise and respect the purpose and effect of Pillar Two.

In addition to the double tax outcomes, similar to the above we expect it would be challenging for the Federal Government to explain to the OECD and its Inclusive Framework members that Australia has determined some of the Inclusive Framework members to be low tax jurisdictions under Australian law, despite those jurisdictions being fully compliant with Pillar Two.

As the most administratively simple approach, we strongly recommend a carve-out for MNEs that are subject to Pillar Two. From a timing perspective, it would be reasonable for this carve-out to become operative once foreign Pillar Two rules (including domestic minimum taxes) are effective (i.e. the intangibles measure would ultimately apply to MNEs for an interim period only).

Alternatively, GloBE and domestic minimum top-up taxes must be accounted for in the determination of 'low corporate tax jurisdiction'. A possible mechanism of how this could be achieved is discussed further below.

## Principal purpose and sufficient economic substance

The explanatory memorandum (**EM**) states that the intangibles measure is an anti-avoidance rule and describes the measure as targeting arrangements that involve a structuring element.

<sup>1</sup> Pillar Two also includes the Subject To Tax Rule.

Yet, inconsistently, there are no exceptions for the following:

- Arrangements that are not carried out for a principal purpose of enabling a tax benefit (**PPT**); and/or
- Arrangements that have sufficient economic substance (unless under the preferential patent box regime test).

No rationale is provided in the EM as to the absence of one or both of these features. Both the PPT and sufficient economic substance test are well understood concepts in the income tax law and are present in other Australian and foreign anti-avoidance and integrity measures. For example, the Australian diverted profits tax (**DPT**) includes both concepts, and a PPT is a feature of other measures such as the multinational anti-avoidance law (**MAAL**) and hybrid mismatch financing integrity rule in Subdivision 832-J *Income Tax Assessment Act 1997 (ITAA97)*. Many of Australia's tax treaties include a PPT. The United Kingdom (**UK**) Offshore Receipts in respect of Intangible Property (**ORIP**) regime does not apply where substantially all of the intellectual property related business activity has always been undertaken in the territory of residence.

We strongly recommend a PPT and sufficient economic substance test are included in the intangibles measure, to restrict its application to circumstances where a multinational group seeks to obtain a tax (including foreign tax) benefit from the arrangement and undertakes artificial structuring. The inclusion of a PPT would also make it more consistent with the BEPS 2.0 approach, and would provide more certainty in relation to its interaction with Australia's double tax agreements (see further below).

### Groups headquartered in a low tax jurisdiction

Where an ultimate parent entity of a multinational group is a tax resident of a low tax jurisdiction, an exception should be provided for payments made to the ultimate parent entity (or an associate that is resident in that same jurisdiction). That is, groups that are headquartered in low corporate tax jurisdictions should not be adversely impacted by this measure.

In these circumstances, it is uncommon for there to be structuring of the kind referred to in the EM in the form of relocating intangible assets in the jurisdiction that provides the most favourable tax outcome (EM at 1.22), particularly given that, in our experience intangible assets of the group are often held in the parent jurisdiction.

The lack of such an exception does not align with the comments in the EM which describe the measure as targeting arrangements that involve a structuring element. This exception is present in the hybrid mismatch financing integrity rule, and the legislative drafting in subsection 832-725(5) ITAA97 could be adopted for this purpose.

The lack of such an exception is also inconsistent with the ATO's views in Practical Compliance Guideline PCG 2017/4, which sets out the ATO's compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions. The PCG's motivational risk scoring table includes the applicable tax rate of the lender entity jurisdiction as an indicator, and states that no points should be assigned where the lender is the parent (even if in a low tax jurisdiction).<sup>2</sup>

## Low corporate tax jurisdiction

Given the intentional breadth of the 'exploiting an intangible asset' test, the low corporate tax jurisdiction test should operate in a straightforward and objective manner. This will allow taxpayers and the ATO to identify in-scope payments with certainty, thus mitigating the risk of substantive compliance activity and disputes.

Given this, as well as our observations below in relation to multiple problems with proposed drafting, we recommend the Federal Government publish a list of jurisdictions that qualify as low corporate tax jurisdictions (which is reviewed on an annual basis). As an alternate, the low tax jurisdictions could be identified by way of regulations. Such a list would reduce complexity as well as compliance and administration costs. This would be consistent with other measures, including the 'listed' versus 'unlisted' country concept in the Australian controlled foreign company (**CFC**) rules, the European Union list of non-cooperative jurisdictions, and the Dutch Government's list in connection with its withholding tax on interest payments and

<sup>2</sup> Furthermore, no risk points should also be assigned where the lender is "a subsidiary of the ultimate parent entity, whose ownership chain remains in the same jurisdiction as the ultimate parent entity, and it and all

members of its ownership chain are taxed as corporations in the parent's jurisdiction" (*Practical Compliance Guideline PCG 2017/4* at pp 92).

royalties to low tax jurisdictions and in abusive situations measure.<sup>3</sup>

It appears from the EM at 1.7 that the intention is for this test to be a 'headline' rate test. However, proposed section 960-258 does not achieve this objective and should be reconsidered. The proposed drafting can also give rise to unintended and inequitable consequences. In this regard, we observe the following:

- The proposed drafting of subsection 960-258(1) indicates that whether a jurisdiction is considered a low corporate tax jurisdiction is a question of fact made on a per country basis, regardless of the tax profile of the foreign resident or its global group. This is because the test operates to deem a foreign country to be in-scope of the measure, without requiring any analysis from the perspective of the foreign resident of the relevant MNE group. This infers that every significant global entity (**SGE**) group will need to form its own view on a particular country.
- It is not clear how a 'foreign country' should be defined for the purpose of these rules. That is, whether jurisdictions such as colonies and territories (e.g. Hong Kong) should be regarded under this measure. The CFC rules provide definitions for this term in section 320 *Income Tax Assessment Act 1936 (ITAA36)*, however the intangibles measure does not link to this definition.
- It is not clear whether the intention is for the list of disregarded items at subsection 960-258(2)(a) to be exhaustive. If so, it is too narrow as there are other "things" which reduce taxable income or tax payable, such as tax exemptions (e.g. branch profits exemptions, participation exemptions), tax rebates, tax holidays, and tax concessions (noting only concessions for intragroup dividends are included at subsection 960-258(2)(a) – it is not clear why this is the case).
- The EM states at 1.55 that only national level corporate tax rate is relevant. This will lead to differing outcomes for taxpayers who make payments to an entity resident in a jurisdiction which administers its income tax at a federal, state and/or municipal level, as opposed to a jurisdiction that levies income tax only at a federal level. State and

municipal taxes should be recognised as they reflect the full corporate tax that an entity will ultimately be subject to. This is particularly relevant to Switzerland's cantonal and communal taxes. The proposed approach is inconsistent with the financing integrity rule which includes these taxes in its 'subject to foreign income tax' test (subsection 832-725(1A) disregards subsections 832-130(7)(d) and (e)). If this is not the policy, this should be made explicit.

- The wording in subsections 960-258(2)(d) and 960-258(2)(e) is vague and the intention is not clear. These subsections read as though they apply to set a lower rate where the foreign country has different rates of income tax (or applies no income to an amount of income). That is, the rules disregard whether the foreign resident actually derives that income or is actually subject to that reduced or nil rate of tax. If this interpretation is correct, then almost all jurisdictions could be low corporate tax jurisdictions, given it is very common for jurisdictions (including Australia) to provide exemptions or reduced tax rates on certain types of income (e.g. foreign branch profits exemption or participation exemption).
- Clarification should be provided in the EM in relation to the treatment of transactions that are disregarded or eliminated under foreign tax consolidation / grouping rules. We expect the intention is for subsection 960-258(2)(d) to apply only where a foreign law applies no income tax on a particular class or category of income. Hence, the position should be confirmed for payments that may be effectively excluded from the tax base in a foreign jurisdiction but do not fall within subsection 960-258(2)(a).

Further to the above, it is not clear how this test should work in the context of a jurisdiction which provides i) concessional rates of tax (below 15 percent) on certain types of income or activities, or ii) exempts certain types of income, but otherwise the ordinary corporate headline tax rate is above 15 percent. In addition, it is not clear whether it makes a difference if the foreign resident indeed derives that type of income or is subject to that concessional treatment. We provide the following illustrative examples:

<sup>3</sup> The Netherlands measure applies to payments to countries with a corporate tax rate of under 9 percent and

to countries on the EU list of non-cooperative jurisdictions.

- Certain dividends are exempt from income tax in the UK. Does this mean the UK is a low corporate tax jurisdiction because of subsections 960-258(2)(d) and 960-258(2)(e)? Malta has a headline corporate tax rate of 35 percent but can provide a tax refund in respect of dividends, commonly a refund of 6/7ths (i.e. 30 percent). Again, does this mean Malta is a low corporate tax jurisdiction?
- How should this test work in the context of Singapore which may provide a reduced corporate tax rate on income derived from certain qualifying activities under its various incentive programs, but the headline corporate tax rate is at 17 percent?
- Focusing on intangibles, what is the position where a foreign jurisdiction (headline rate above 15 percent) has a patent box regime with sufficient economic substance which offers a lower corporate tax rate? The proposed drafting suggests that the jurisdiction is deemed a low corporate tax jurisdiction. For example, the UK and Indian patent box regimes reduce the corporate tax rate to 10 percent for qualifying income. There are also jurisdictions which have regimes that could result in an 'effective tax rate' below 15 percent in connection with intangibles (notably, the United States Foreign Derived Intangible Income rules). Indeed, if looking in reverse to Australia, would the effective 3 percent rate applicable to non-resident insurers under Division 15 ITAA36 or the effective 10 percent rate formerly applicable to Offshore Banking Unit income under Section 121EG ITAA36 be treated as low corporate tax rates if these regimes existed in a foreign country?

In the alternate scenario, it is not clear how this test should work where a jurisdiction provides a higher rate of tax on certain types of income (above 15 percent), but otherwise the headline tax rate is below 15 percent. For example, Ireland can tax passive royalty income at a rate of 25 percent. The rules appear to treat this jurisdiction as a low corporate tax jurisdiction. This may be the intention, but it is unclear whether this remains the case where the foreign resident is actually subject to the higher rate of tax on the income earned directly from the payment by the taxpayer. If so, this outcome would appear inequitable.

Our comments above demonstrate that there are challenges with establishing a headline rate test

that operates reasonably and equitably, although the concept may be simple. We provide an alternative that should be considered by Treasury at the conclusion of our submission.

### Preferential patent box regime

In relation to the second limb of the low corporate tax jurisdiction test, we consider more certainty should be provided to the SGE groups that rely on preferential patent box regimes that are compliant with the OECD's Action 5 Harmful Tax Practices. At the very least, the Minister should be compelled to have regard to the OECD's findings, determinations etc (under the proposed drafting, the Minister 'may' have regard to the OECD's findings, determinations etc). However, it would be best if a regime that is Action 5 compliant could not be determined to be a low corporate tax jurisdiction by the Minister. This would avoid any unilateral departure from OECD findings, give surety to groups and would be more aligned with the measure's intention.

### Exploiting intangible assets

We acknowledge the intention is for 'exploiting an intangible asset' to take a broad meaning to capture the variety of ways in which intangible assets can be exploited in the business of a group. However, given the potential breadth of operation of section 26-110, we consider the activities that could fall within the exploitation of an intangible asset test to be pervasive. There is therefore a risk that very routine activities and/or activities connected with genuine third-party commercial arrangements are in-scope. The following are examples:

- Where a foreign parent has a licence or other form of right to use third-party software (e.g. application software), mere access by taxpayer personnel to the group's global intranet site could be in-scope (e.g. use of a site search function, downloading a copy of an internal policy document or use of an online form) because these activities could be considered the 'use' of the parent's rights in the third-party software.
- Where a global group collates information on a central database, the information may not be related to customer sales, marketing etc, but will nevertheless fall within the definition (e.g. global personnel directory, preferred supplier lists, or financial reporting data).

As such, we recommend the test is updated to focus on arrangements beyond a mere "simple

use” that are connected with a global group’s core set of intangibles.

### Tangible asset exceptions

We suggest further guidance is provided in the EM in relation to the types of arrangements that are intended to be excluded by the exception for tangible assets (subsections 26-110(7)(a) and 26-110(7)(d)). This should include additional examples.

#### Shares in a company

Subsection 26-110(7) should be updated so that shares or other rights in relation to a company are excluded from the intangible asset definition. Consistent with the other exclusions, these assets are also less mobile and subject to other regulatory frameworks. The UK ORIP rules have this exclusion.

### Distributor arrangements

We understand the intention is that this measure should not apply to genuine supply and distribution arrangements where there is no tax avoidance behaviour (EM at 1.47). However, it is not sufficiently clear as to how the intangible asset exception(s) would apply in practice to exclude these arrangements. We therefore recommend a more administratively simple approach to carve-out these arrangements from the measure.

There is uncertainty which should be clarified in relation to the examples provided in the EM of a distributor who sells branded finished goods to customers:

- The example at 1.32 provides a description of an in-scope arrangement where a reseller of finished goods uses a trademark to brand Australian stores and marketing materials.
- The example at 1.47 then provides that the ‘mere’ marketing and selling of finished goods (with printed trademarks) is ‘unlikely’ to be in-scope.

It is not apparent from the latter example how, practically, the taxpayer markets and sells the goods without any exploitation of intangible assets (i.e. how is the distributor marketing and selling the products in this example, and why would such an arrangement fall out of scope as compared to the branding of stores and materials in the earlier example).

The example at 1.47 should also be updated to make explicit the basis for this example falling

within the tangible asset exception. We assume the rationale is as follows:

- The finished goods are tangible assets;
- The trademark on the finished goods is therefore a right in respect of a tangible asset (excluded under subsection 26-110(7)(a)); and
- Therefore, the taxpayer’s (incidental) use of the trademark is a right in respect of an intangible asset that is excluded from the intangible asset definition by virtue of subsection 26-110(7) (i.e., excluded under subsection 26-110(7)(d)).

However, it is not clear why the tangible asset exception does not apply in the example at 1.32.

These examples should be reconciled and distinguishing features of in and out of scope arrangements clearly explained. The examples should also be updated to canvass a range of common distribution channels (e.g. wholesale, retail, online, marketplaces and through third-party distribution partners) and whether displaying the brand or trademark/ tradename as part of the marketing and selling process will lead to different conclusions on whether the arrangement is in or out of scope.

### Indirect payments

The EM states that strict tracing through the flow of funds is not required in determining whether income is derived indirectly from the exploitation of an intangible asset (subsection 26-110(2)(c)).

The wording in the EM at 1.34 mirrors the legislative provision of the imported hybrid mismatch rule (subsection 832-625(3)(a)). If the intention is for indirect payments under the intangibles measure to be determined consistent with the imported hybrid mismatch rules, it would be clearer if the legislative provision were updated.

The measure as currently drafted applies to ‘arrangements’ and ‘related arrangements’. Guidance in the EM should be provided as to how the relevant ‘arrangements’ and ‘related arrangements’ should be identified for purposes of assessing the application of these rules.

## Mischaracterisation

In relation to so called mischaracterisation and the apportionment between intangible and non-intangible components of a payment (allowable under the proposed drafting), we consider that in



practice this exercise will be very difficult and resource intensive, requiring detailed transfer pricing analysis as well as valuations to achieve an appropriate outcome. Guidance should be provided to enable taxpayers to undertake this bifurcation exercise. This should comprise guidance in the EM, supplemented by administrative guidance by the ATO.

In particular to reduce compliance costs in circumstances where there is a low risk of loss to the revenue, the ATO should establish “safe harbours” for routine transactions. Further commentary should also be provided (in the EM) on how this bifurcation exercise (including any disputes in relation thereto) interacts with the associated enterprises article, as well as the royalty article (i.e. royalties characterisation), in Australia’s tax treaties.

### Shortfall penalty

A shortfall penalty should not be imposed for mischaracterisations under the intangibles measure.

There will be many instances where the mischaracterisation is unintentional and inadvertent, without any tax avoidance motive. In addition, apart from ensuring royalties are appropriately characterised, taxpayers have generally not had to explicitly identify the exploitation of group intangibles in the manner required by the intangibles measure, and so it would be unreasonable to apply a punitive penalty on top of a denial of deductions. Further, the question of whether there has been a ‘mischaracterisation’ will likely be subjective and difficult to determine.

The existing rules in relation to administrative penalties (i.e. the shortfall penalties for making false and misleading statements, taking a position that is not reasonably arguable and entering into schemes) are sufficiently robust and should be retained. It is important to note that the penalties for SGEs are already doubled under current law, with the increased penalties imposed to help deter tax avoidance and encourage SGEs to better comply with their taxation obligations.

## Pro-rata denial of deductions

There are inequitable consequences from the denial of deductions, and we suggest the following mechanisms to allow for partial denials:

- As currently drafted, where a payment is in scope of the intangibles measure, the whole payment is denied a deduction if it wholly

relates to exploiting an intangible asset. No regard is given to the extent to which the low tax jurisdiction is below the 15 percent threshold – for example, a payment to Ireland (headline rate of 12.5 percent) is treated in the same way as a payment to a jurisdiction with no corporate tax. To operate fairly, a mechanism to provide a pro-rata denial should be included (e.g. at most only 17 percent of the payment to Ireland should be denied (i.e.  $(15 - 12.5) / 15$ ), while the payment to a jurisdiction with no corporate tax should have a 100 percent denial).

- The intangibles measure should also be updated so that a deduction is only denied to the extent the income is ultimately derived in a low corporate tax jurisdiction. Subsection 26-110(2) is drafted such that merely the existence of income (even a nominal amount) in a low corporate tax jurisdiction is potentially sufficient to cause the entirety of the payment made by the taxpayer to be in scope of the intangibles measure (and therefore non-deductible). An example here is where the taxpayer makes a payment of \$100 to a foreign associate (non-low corporate tax jurisdiction). The foreign associate retains \$99 and on-pays \$1 to another foreign associate (in a low corporate tax jurisdiction). Rather than denying a deduction for the whole \$100 payment, a more equitable outcome would be to allow a pro-rata denial to the extent of the \$1, given the \$99 is derived in a non-low corporate tax jurisdiction.

## Australian tax

### Withholding tax (WHT)

The low corporate tax jurisdiction test does not account for the payment of Australian WHT on royalties paid to non-residents, and we see no policy basis for this. If Australia has collected WHT, this should proportionally increase the foreign resident’s tax rate for the purpose of this test, so as to avoid double tax outcomes. The double tax outcomes under the proposed drafting are outlined below (putting aside any tax credits):

- A royalty paid to a non-resident in a non-treaty country is subject to 30 percent WHT and the royalty deduction is denied.
- Similarly, a royalty paid to a non-resident in a treaty country is subject to the reduced treaty rate (plus taxed in the hands of the recipient) and the royalty deduction is denied.

Consideration could be given to the inclusion of a specific anti-avoidance rule to address any risk of taxpayers mischaracterising payments as royalties to avoid a deduction being denied under the intangibles measure.

### Controlled foreign company (CFC) attribution

The low corporate tax jurisdiction test does not account for the payment of Australian income tax. Under the Australian CFC rules, where an Australian company makes an in-scope payment to a CFC in an unlisted country, the Australian company may be subject to income tax on an attribution basis in respect of the payment. But the Australian company would also be denied a deduction for the payment under the intangibles measure. The intangibles measure should be updated to prevent this double tax outcome.

The hybrid financing integrity rule includes such a mechanism by accounting for Australian income tax (subsection 832-725(1)(f) ITAA97). Therefore, we suggest the ‘subject to Australian income tax’ test (section 832-125 ITAA97, and specifically subsection 832-125(3)) could be used in the intangibles measure.

### Foreign CFC taxes

The low corporate tax jurisdiction test does not account for taxes paid in relation to CFCs under foreign tax laws. By way of illustration, where a payment is made by a taxpayer to a foreign company in a low corporate tax jurisdiction, but the payment is included in the tax base of another foreign company (non-low corporate tax jurisdiction) because of the operation of that jurisdiction’s CFC rules, it is unreasonable for there to be a denial of deductions as the payment is ultimately not low-taxed.

As such, any foreign income tax paid as a result of a CFC regime inclusion should be taken into account in determining whether the 15 percent threshold has been met. The hybrid mismatch rules include such a mechanism through the ‘subject to foreign income tax’ test, which recognises the effect of CFC regimes (subsection 832-130(5) ITAA97). This test could be adopted for the intangibles measure.

### Interactions with existing income tax laws

To ensure reasonable outcomes and no double tax is applied, clarity should be provided in relation to the interaction between the intangibles

measure and the operation of other integrity measures such as the MAAL, DPT, etc as well as the transfer pricing reconstruction rules.

Further, the intention as to the position of the intangibles measure in the context of Australia’s double tax agreements should be confirmed. Given this rule does not sit within Part IVA ITAA36, a double tax agreement will have primacy to the extent there is an inconsistency (s4(2) *International Agreements Act 1953*).

### CFC attributable income computation

Section 389 ITAA36 operates to disregard certain listed provisions (e.g. thin capitalisation rules and hybrid mismatch rules) when computing the attributable income of a CFC. Other regimes explicitly exclude their operation in this situation (e.g. commercial debt forgiveness rules).

Consistent with the treatment of other integrity measures, to avoid double tax outcomes (and the complexity of applying these rules in the context of a CFC attribution calculation) section 26-110 should be disregarded when computing the attributable income of a CFC.

### Associate test

The use of an ‘associate’ test (per section 318 ITAA36) in the intangibles measure is too wide. For companies, the associate test comprises a majority voting interest test or sufficient influence test. As such, whether entities are associates of each other goes well beyond an examination of ‘control’, given the sufficient influence test will be satisfied where the company or its directors are accustomed to act in accordance with the directions, instructions or wishes of others, or are under an obligation to do so (whether formal or informal), or might reasonably be expected to do so.

The breadth of the sufficient influence test was confirmed by the High Court in *BHP Billiton Limited v Commissioner of Taxation* [2020] HCA 5. This test presents complexity and practical difficulties for taxpayers (e.g. there may be many potential ‘associates’ in joint venture arrangements or where taxpayers have minority ownership structures).

We suggest the measure is updated so that it applies to payments in groups that are consolidated for accounting purposes, or where there is majority control. The hybrid mismatch rules include the concept of a Division 832

control group which should be used in the intangibles measure.

## Application of amendments

In relation to the application of amendments, we suggest that it should read “Section 26-110 of the Income Tax Assessment Act 1997 applies to amounts paid, liabilities incurred or amounts credited (whichever is earlier) on or after 1 July 2023.” In situations where one of these events occurs prior to 1 July we consider it reasonable for it to be excluded from the intangibles measure. For example, where a liability is incurred prior to 1 July but the payment is made after 1 July, the arrangement should be excluded from the measure.

## Alignment with financing integrity measure

We consider that many of the concerns raised in our submission could be addressed by adopting the legislative design of the hybrid mismatch financing integrity rule (section 832-725 ITAA97), supplemented with an explicit carve-out for MNEs that are subject to Pillar Two. Key features of the financing integrity rule which could be used for the intangibles measure include:

- Examination of the foreign taxation of the payment, rather than the jurisdictional headline rate. Broadly, an amount of income or profits is subject to foreign income tax if foreign income tax is payable under the law of the foreign country because the amount is included in that country's tax base.
- A PPT.
- Exclusion where the parent entity is headquartered in the low tax jurisdiction.
- Exclusion where the payment is subject to Australian income tax (e.g. Australian CFC rules).
- Exclusion where the payment is taken into account under foreign CFC taxes.
- State and municipal taxes regarded in the determination of foreign income tax.

The financing integrity measure considers indirect payments in a limited context (back-to-back arrangements per section 832-730 ITAA97), so this aspect of the intangibles measure would need additional consideration.

We note the financing integrity does not recognise Australian WHT, so we would recommend an extension of the ‘subject to Australian income tax’ exclusion to include Australian WHT (noting that the maximum rate of withholding that can apply to interest is 10 percent, whereas the maximum rate for royalties is 30 percent).

If an explicit carve-out for Pillar Two is not intended, an alternative could be to exclude payments that are taken into account under domestic or foreign Pillar Two rules (i.e. consistent with treatment of payments taken into account under Australian or foreign CFC rules).





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