

28 April 2023

Ronita Ram  
A/g Assistant Secretary  
Tax Treaties Branch  
Corporate and International Tax Division  
Treasury  
Langton Cres, Parkes ACT 2600

[MNETaxIntegrity@treasury.gov.au](mailto:MNETaxIntegrity@treasury.gov.au)

Dear Ronita

## **Submission on deductions for payments relating to intangible assets connected with low corporate tax jurisdictions**

This submission provides our comments 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 (**the ED**) and the draft Explanatory Material (**the draft EM**), as issued on 31 March 2023.

Our submission comments are in the attached appendix. We would be pleased to discuss any aspect further. Please call any of Claudio Cimetta, Chris Ferguson or David Watkins (0498 344 000).

Yours sincerely



**David Watkins**  
Partner



**Claudio Cimetta**  
Partner

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited ("DTTL"), its global network of member firms, and their related entities (collectively, the "Deloitte organisation"). DTTL (also referred to as "Deloitte Global") and each of its member firms and related entities are legally separate and independent entities, which cannot obligate or bind each other in respect of third parties. DTTL and each DTTL member firm and related entity is liable only for its own acts and omissions, and not those of each other. DTTL does not provide services to clients. Please see [www.deloitte.com/about](http://www.deloitte.com/about) to learn more.

Deloitte is a leading global provider of audit and assurance, consulting, financial advisory, risk advisory, tax and related services. Our global network of member firms and related entities in more than 150 countries and territories (collectively, the "Deloitte organisation" serves four out of five Fortune Global 500® companies. Learn how Deloitte's approximately 312,000 people make an impact that matters at [www.deloitte.com](http://www.deloitte.com).

#### Deloitte Asia Pacific

Deloitte Asia Pacific Limited is a company limited by guarantee and a member firm of DTTL. Members of Deloitte Asia Pacific Limited and their related entities, each of which are separate and independent legal entities, provide services from more than 100 cities across the region, including Auckland, Bangkok, Beijing, Hanoi, Hong Kong, Jakarta, Kuala Lumpur, Manila, Melbourne, Osaka, Seoul, Shanghai, Singapore, Sydney, Taipei and Tokyo.

#### Deloitte Australia

The Australian partnership of Deloitte Touche Tohmatsu is a member of Deloitte Asia Pacific Limited and the Deloitte organisation. As one of Australia's leading professional services firms, Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, risk advisory, and financial advisory services through approximately 8000 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit our web site at <https://www2.deloitte.com/au/en.html>.

Liability limited by a scheme approved under Professional Standards Legislation.  
Member of Deloitte Asia Pacific Limited and the Deloitte organisation. © 2023 Deloitte Touche Tohmatsu.

### Key submission points

Our key submission points can be summarised as follows:

1. The proposed measure is not required as a means of protecting the Australian tax base as the existing law already provides multiple strong safeguards.
2. The forthcoming implementation of the OECD/G20 Pillar 2 rules by many major economies will address concerns with lowly taxed income of any kind, on a multilaterally agreed basis – including income derived in the circumstances contemplated by this measure. As currently drafted, the proposed measure is incompatible with Pillar 2, and should be amended to accommodate the imminent rollout of Pillar 2. It is submitted that the measure should effectively operate as a backstop to Pillar 2.
3. We recognise that the Government remains concerned with low tax outcomes and acknowledge the importance it places on proceeding with its election commitment. We therefore make the following submissions on the design of the proposed measure:
  - (i) The low corporate tax jurisdiction (**LCTJ**) test should be simplified to make it a more straightforward 15% headline rate test that appropriately targets actual low or no tax countries. Also the test should take into account sub-national taxes where relevant.
  - (ii) To ensure that the proposed measure appropriately targets only low tax outcomes, and is compatible with Pillar 2, the measure should not apply if:
    - the aggregate rate of any Australian withholding tax (**WHT**) or foreign WHT paid on the relevant income is at least 15%; or
    - it is reasonable to conclude that the relevant income is taken into account under the controlled foreign company rules in Part X of the ITAA 1936 or under an equivalent law of foreign country, including the US Global Intangible Low-Taxed Income (**GILTI**) rules; or
    - the recipient of the relevant income is subject to a Qualified DMTT, a parent entity is subject to a Qualified IIR, or any member of the relevant group is subject to a Qualified UTPR, as defined in the GloBE Rules published by the OECD/G20 Inclusive Framework in December 2022.
  - (iii) Where the proposed measure applies to deny a deduction, the amount of deduction denied should be limited to the amount necessary to ensure that the applicable tax rate is increased to a 15% minimum tax (i.e. it should **operate as a top-up tax** that eliminates the under-taxation).
4. If the design changes outlined above are not made, the proposed rule would result in exceptionally high double Australian taxation (e.g. at least 60% if Australia's CFC rules apply) and exceptionally high international double taxation (e.g. at least 45% if another country's Pillar 2 rules apply).
5. As the scope of the relevant payments is drafted in an exceptionally broad fashion, the Explanatory Memorandum should contain detailed examples that clearly identify "genuine supply and distribution arrangements" and other scenarios, which are not intended to be in scope.

### Overview

The proposed measure can result in taxation outcomes that are inconsistent with the arm's length principle, give rise to double taxation and are inconsistent with current and emerging international tax norms. Furthermore the

scope of payments to which the measure could apply is so broad as to be unworkable in practice, whether by taxpayers or the ATO.

The measure should be better targeted and integrated with the existing strong Australian tax laws and impending Pillar 2 changes.

### Existing Australian law and protection of the Australian tax base

In respect of the Australian tax base, the proposed measure is not required as the existing law already provides multiple strong safeguards. These safeguards include:

- the definition of “royalty”, which presently addresses so-called mischaracterisation cases as it covers payments “however described or computed” for the use of, or the right to use, relevant intangibles. This point, amongst others, is currently the subject of Federal Court litigation;
- section 26-25 ITAA 1997, which denies deductions for payments on which WHT is payable in Australia but has not been paid;
- the hybrid mismatch rules, which for example deny deductions for payments that import an offshore hybrid mismatch or result in a reverse hybrid mismatch;
- the principal purpose test in bilateral treaties or imposed by the multilateral instrument, which denies reduced WHT rates under tax treaties where one of the principal purposes of an arrangement was to obtain those benefits;
- the transfer pricing rules, which deny deductions for payments that are excessive relative to the functions, assets and risks outside Australia, and also address mischaracterisation by disregarding the form of actual commercial or financial relations to the extent it is inconsistent with their substance; and
- the diverted profits tax, which allows the ATO to counteract schemes that involve lowly taxed foreign entities with insufficient economic substance and were entered into for a principal purpose of obtaining Australian and foreign tax benefits.

Although the interaction of the proposed measure with these provisions is not expressly addressed, we proceed on the basis that all of these provisions are intended to continue to operate in their usual way. As drafted, the proposed measure could apply **in addition** to these provisions. For example, it would be possible for in scope payments to be subject to royalty WHT at up to 30% and then subject to a further round of Australian tax, effectively at 30%, resulting in double Australian taxation.

### Policy objective

The Government’s principal policy concern is with “insufficient tax”<sup>1</sup> outcomes or “avoiding corporate income tax”<sup>2</sup> arising from payments relating to intangible assets within large multinational groups.

In context, the concern is insufficient tax imposed on a non-resident deriving income that is in some way connected with the exploitation of an intangible and is in some way connected with Australia. Given the identification of a 15% rate, it can be inferred that taxation of such income at a rate of least 15% of the net income would be “sufficient”. On that basis, any outcome that results in taxation of such income above that policy benchmark ought not be in scope.

As drafted, the concept of LCTJ is extremely broad and will capture income arising in jurisdictions which are technically regarded as a LCTJ (as drafted) even though the income is subject to tax at or above the policy benchmark, either in the LCTJ or elsewhere.

---

<sup>1</sup> Refer paragraph 1.16 of the Draft EM

<sup>2</sup> Refer section 26-110(1)

We propose a number of modifications which could be made to the LCTJ test, so as to narrow the scope of the measure so that it does not capture amounts taxed at or above the policy benchmark.

Relevant to this, we note that the original thinking associated with the proposed measure can be traced back to 2019.<sup>3</sup> Since that time, Pillar 1 and 2 have been conceived and developed<sup>4</sup>. Australia has been a strong supporter of the global multilateral response to low taxed income. Implementation of Pillar 2 is expected to begin in 2024. It is submitted that any remaining concerns with low tax outcomes should be addressed by the various elements of Pillar 2. Given that we are on the cusp of the global rollout of Pillar 2, this measure should be modified to ensure that it is integrated with the Pillar 2 responses.

### In scope payments

We are concerned that the adoption of extremely broad concepts, linkages and definitions (including “arrangements”, “exploiting intangible assets” and “low corporate tax jurisdiction”, amongst others) at multiple points in the Exposure Draft will mean that taxpayers will be unable to reliably self-assess their compliance.

### Structure of this submission

Nonetheless, we recognise the Government’s policy concern and acknowledge the importance it places on implementing its election commitment regarding payments relating to intangible assets. This submission therefore focusses on the design of the proposed measure in three key areas:

1. the design of the low foreign tax rate trigger;
2. the amount of Australian tax that should be imposed if the measure is triggered; and
3. the scope of payments relating to intangible assets to which the measure would apply.

---

<sup>3</sup> Refer “Labor will crackdown on loopholes for multinationals - Media Release”, 5 May 2019  
[https://www.andrewleigh.com/labor\\_will\\_crackdown\\_on\\_loopholes\\_for\\_multinationals\\_media\\_release](https://www.andrewleigh.com/labor_will_crackdown_on_loopholes_for_multinationals_media_release)

<sup>4</sup> The origins of Pillar 1 and 2 can be traced back to the Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy of January 2020

## 1. Design of the low tax trigger

### Introduction

Given that the underlying policy concern is expressed to be an “insufficient tax” outcome, the low tax trigger should not be based on a very wide LCTJ concept (as presently drafted), but should be more targeted both in the definition of LCTJ and also in having regard to other income taxes that are imposed on the relevant payments. It is submitted, given the policy objective, that the following should be taken into account in setting the low tax trigger:

- Australian tax paid (e.g. WHT);
- foreign taxes (including WHT) that may be paid under existing laws; and
- foreign taxes that may be paid by way of the Pillar 2 responses.

These points are addressed in more detail below.

### Legislative proposal

The ED requires the identification of a LCTJ “in” which an associate of the payer derives income from exploiting the relevant intangible asset (or from a related intangible asset).<sup>5</sup>

The definition of LCTJ is based on a headline rate of less than 15%, with various modifications.<sup>6</sup>

### Specific concerns

#### The definition of LCTJ is far too broad as it is based on the lowest rate on any type of income in the country

We note that the EM states that the object is to “ensure that the amendments capture the relevant rate that is likely to apply to the income of the SGE”<sup>7</sup>. However, as drafted, the various proposed adjustments to the headline rate would mean that the trigger is the lowest tax rate applicable to any type of income in the country (due to the operation of paragraphs 960-258(2)(d) & (e)). Accordingly the low tax rate trigger may be activated by an exemption or concession completely unrelated to intangibles, and completely unrelated to the relevant parties, arrangements and payments.

As drafted, the LCTJ concept would likely result in all “listed countries”<sup>8</sup> and most OECD member states being LCTJs, due to common features such as exemptions for foreign non-portfolio dividends,<sup>9</sup> foreign branch profits or other exemptions or concessions for particular types of income, which may have nothing to do with the exploitation of intangibles.

It is assumed that the concept of LCTJ was intended to effectively target a relatively small group of countries, which either do not have a corporate income tax or impose corporate income tax at an unusually low rate.

#### The concept of an associate deriving income in a LCTJ is unclear

The operation of proposed section 26-110 is based on an associate deriving relevant income “in” a low corporate tax jurisdiction. The concept of “deriving income in” a particular jurisdiction does not have a recognised meaning

---

<sup>5</sup> Section 26-110(2)(c)

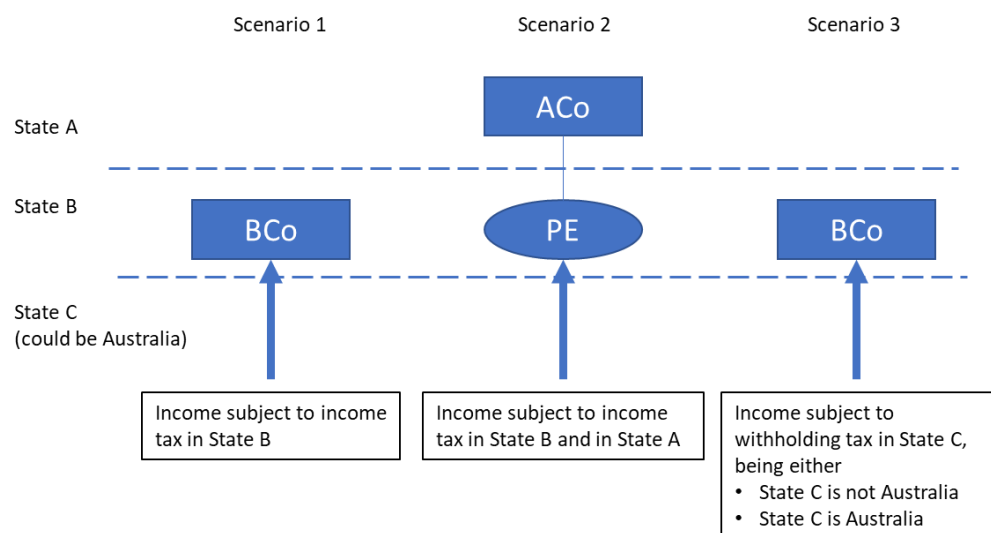
<sup>6</sup> Section 960-258

<sup>7</sup> Paragraph 1.57 of the draft Explanatory Memorandum

<sup>8</sup> I.e. United States, the United Kingdom, Germany, France, Canada, Japan and New Zealand, being the countries identified by existing Australian tax law as having tax systems closely comparable to that of Australia.

<sup>9</sup> Disregarding concessions for “intra-group” dividends as proposed in paragraph 960-258(2)(a) would not be sufficient to appropriately identify LCTJs, as non-portfolio shareholdings (i.e. holdings of 10% or more) would not necessarily give rise to a “group” relationship as generally understood, and would result in the country being a LCTJ.

and its scope is not clear. This should be clarified, potentially by using the well-recognised concepts of residency and permanent establishment. Consider the examples below:



- Is income relevantly taken to be **derived in** State B in all of these scenarios?
- Is income relevantly taken to be **derived in** State A in scenario 2?
- Is income relevantly taken to be **derived in** State C in scenario 3?

## The definition of LCTJ should take into account sub-national corporate income taxes

The EM states that “Only national level corporate tax is relevant for determining whether a foreign country is a low corporate tax jurisdiction”.<sup>10</sup> However there does not appear to be any reason why sub-national corporate income taxes (e.g. cantonal taxes in Switzerland) should not count for the purpose of testing the LCTJ status of a jurisdiction. The policy goal of preventing low tax outcomes would be achieved regardless of whether the tax is paid to a national or sub-national tax authority.

We note that for the purpose of applying the hybrid mismatch integrity rule relating to interest (subdivision 832-J), in working out whether foreign income tax has been imposed on the payment in a foreign jurisdiction, any foreign municipal taxes and State taxes are taken into account (refer s832-725(1A)).

## The proposed measure should take into account taxes that may be imposed by other countries via withholding

Taxes imposed by withholding in a source country (which could be either Australia or a foreign intermediary country, due to the look-through nature of the proposed measure)<sup>11</sup> should be taken into account. In the absence of this, the proposed measure may deny deductions for payments that are taxed at substantially more than the policy benchmark. For example, a denial of deductions by the proposed measure would result in the gross amount of income that is already subject to Australian WHT at 15% or 30% becoming subject to an effective Australian rate of 45% or 60%.

Further, not taking into account WHT that is actually paid is anomalous given one of the stated reasons for the measure being introduced is to address the avoidance of WHT.<sup>12</sup>

<sup>10</sup> At paragraph 1.55

<sup>11</sup> Paragraph 26-110(2)(c) includes income derived by an associate of the recipient of the payment made by the Australian payer, directly or indirectly from exploiting the intangible asset or a related asset.

<sup>12</sup> E.g. paragraphs 1.13 & 1.17 of the draft Explanatory Memorandum.

## The proposed measure should take into account taxes that may be imposed via CFC or equivalent rules

Assume that a relevant payment is derived in a LCTJ, and that the relevant amount is subject to tax in the hands of a parent company pursuant to controlled foreign company (CFC) rules of a parent jurisdiction. Such taxes imposed in the parent jurisdiction should be taken into account by the proposed measure. Again, failure to do so could result in denial of deductions for payments that are taxed at a rate substantially greater than the policy benchmark.

For example, an Australian based group may make in-scope payments to a group entity that is in a LCTJ, whose income is subject to tax at 30% via the Australian CFC provisions. As drafted, the denial of deduction by the proposed measure would result in income that is already subject to Australian tax via Australia's CFC rules being subject to an effective Australian rate of 60% or more (noting that the denial is effectively a 30% tax on the gross in scope amount). Where income derived in a LCTJ is taken into account under Australia's CFC rules or under an equivalent law of a foreign parent jurisdiction (including the US GILTI rules), this should also be taken into account by the proposed measure.

## The proposed measure should take into account taxes that may be imposed following the implementation of Pillar 2

### *Overview of Pillar 2*

In October 2021, over 135 members of the OECD/G20 Inclusive Framework, representing more than 95% of global GDP, endorsed the adoption of Pillar 2 to introduce a global minimum corporate tax rate of 15%. The Pillar 2 rules consist of a co-ordinated system of interlocking rules that impose a top up tax in accordance with an agreed rule order, which is broadly as follows:

- a Domestic Minimum Top-up Tax (DMTT), which may be imposed by the residence jurisdiction of the group member that earned the relevant income;
- an Income Inclusion Rule (IIR), which may be imposed by the jurisdiction of the ultimate parent entity (UPE) (or failing that, the jurisdiction of an intermediate parent), if the jurisdiction of the group member that earned the income does not impose sufficient tax via normal corporate income tax or a qualified DMTT; and
- an Undertaxed Profits Rule (UTPR), which may be imposed by the jurisdictions in which other group members reside, in accordance with an agreed allocation formula, if jurisdiction of the group member that earned the income does not impose sufficient tax via normal corporate income tax or a qualified DMTT, and there is no ultimate or intermediate parent jurisdiction that imposes a qualified IIR.

The Pillar 2 rules also take into account withholding taxes that may be imposed by a source jurisdiction (which are factored into the ETR for the residence jurisdiction of the group member that earned the relevant income) and CFC taxes that may be imposed by a parent jurisdiction (which are factored into the ETR for the underlying residence jurisdiction for the purposes of the IIR and UTPR).

Various major economies have now commenced the process of implementing these Pillar 2 rules or have announced their intention to do so.

### *Incompatibility of proposed measure with Pillar 2*

The proposed measure does not take into account any of the above developments. Consequently, the proposed measure as currently drafted is incompatible with the globally agreed Pillar 2 standards and will likely result in double taxation after Pillar 2 begins to take effect (expected from 2024 or 2025 in many major economies). In particular:

- The definition of LCTJ only takes into account the rate of "corporate income tax" in the relevant country. This may not cover a qualified DMTT imposed by the same country, even though it would increase the effective tax rate in that country to 15%.

- The additional 30% tax imposed on the Australian payer, due to the denial of a deduction, would not count towards the jurisdictional ETR for the recipient of the payment. Consequently, the recipient's tax rate may appear to be less than 15%, resulting in further tax being imposed via another jurisdiction's IIR or UTPR.

The proposed measure would therefore result in an effective tax rate of at least 45% due to:

- the proposed measure imposing Australian tax at 30% without taking into account a 15% minimum already imposed by a qualified DMTT in "LCTJ"; or
- a foreign IIR or UTPR imposing a "top-up" to the 15% minimum with respect to the LCTJ without taking into account the Australian tax already imposed at 30% by the proposed measure.

The OECD's recent publication on tax certainty for the GloBE Rules stated as follows (emphasis added):<sup>13</sup>

6. The recognition of a "qualified" rule status for an IIR, a UTPR or a DMTT is a fundamental mechanism for ensuring the coordinated application of the GloBE Rules. This coordination through the agreed rule order is achieved by limiting or modifying the application of the rules in one jurisdiction where there is an applicable "qualified" rule in another jurisdiction.

7. The identification of Qualified IIRs, UTPRs and DMTTs will be done through a review process ... almost any difference in the implementation of the GloBE rules has the potential to undermine the agreed rule order and the outcomes provided for under the Model Rules and Commentary.

As currently drafted, the proposed measure would upend the multilaterally agreed rule order by creating an Australian tax charge that would apply in priority and in addition to all of the Pillar 2 responses on income arising from functions, assets and risks located outside Australia, and would not count as a Covered Tax when other countries are determining the application of Pillar 2 to the same income.

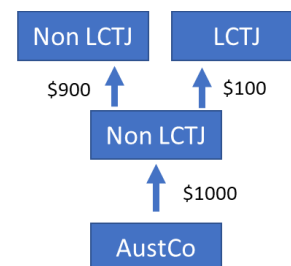
Conceivably, there could even be triple Australian taxation, if a payment is subject to Australian WHT, is non-deductible under the proposed measure and is taxed again under an Australian UTPR, based on the jurisdictional ETR of the income recipient computed according to the agreed global standard.

## The measure appears to apply to the whole of an attributable payment regardless of how much is ultimately derived in a LCTJ

Section 26-110 is drafted so that the measure applies only to so much of a payment that is attributable to a right to exploit an intangible asset. This test contains an appropriate "to the extent" test to identify the (broadly speaking) intangible related component of a larger payment. However, having so identified the intangible related component, the measure then proceeds on the basis that the provision can apply to deny the deduction for the whole of the intangible related component if the arrangement, etc "results in [an associate] deriving income in a [LCTJ]". The measure does not appear to be refined so as to only apply to so much of the intangible related component as is derived in a LCTJ.

Assume a scenario as follows (and for the sake of simplicity, assume there are no other relevant expenses):

- Austco pays an amount of \$10,000 to an associate (first recipient) of which \$1,000 is attributable to a right to exploit an intangible asset. The first recipient is not in a LCTJ
- The first recipient makes two related on-payments to associates
  - \$900 is derived by an entity which is in a non LCTJ
  - \$100 is derived by an entity which is in a LCTJ



<sup>13</sup> Pillar 2 – Tax Certainty for the GloBE Rules, OECD December 2022



As we read Section 26-110, it appears that the whole of the intangible related component of \$1,000 is non-deductible, notwithstanding that \$900 is derived in a non-LCTJ and likely subject to tax at a more than sufficient rate. The same result would appear to arise if the \$900 is instead paid to unrelated parties for normal operating expenses.

Leaving aside the complex apportionment, to the extent and attribution issues, this is another demonstration of the excessive scope of this measure. Conceptually, the measure should only apply to so much of the intangible related component as is not subject to sufficient tax.

## Submission points on the low tax trigger

To address the above concerns, we make the following submissions:

- (i) The definition of LCTJ in section 960-258 should be simplified to make it a more straightforward headline rate test. In particular, paragraphs 960-258(2)(d) and (e) should be omitted. This would have the result that concessionally taxed income in higher tax countries (e.g. US FDII and UK patent box) is not captured by this proposal (with the exception of any preferential patent boxes designated under 960-258(3)). As a consequence, the reference in paragraph 960-258(1)(a) to “concessions for intra-group dividends” could also be omitted.
- (ii) Sub-national taxes should be taken into account for testing LCTJ status, similarly to the existing test in the targeted integrity rule and the definition of Covered Taxes for Pillar 2.<sup>14</sup> To achieve this, paragraph 960-258(1)(a) could be amended to read along the lines of “the total rate of corporate income tax under the laws of that foreign country (including the laws of a relevant political subdivision or local authority)”.

Even where an amount of relevant income is relevantly derived in a LCTJ, the proposed measure should not apply in the following cases:

- (iii) The proposed measure should not apply if the aggregate rate of any Australian WHT or foreign WHT paid on the relevant income is at least 15%. This is consistent with the policy goal and the Pillar 2 treatment of WHT as Covered Taxes allocable to the entity that earned the income. Indeed, WHT imposed at 15% represents a 15% tax on the gross amount, which will be considerably more than the policy benchmark.
- (iv) The proposed measure should not apply if it is reasonable to conclude that the relevant income is taken into account under the CFC rules in Part X of the ITAA 1936 or under an equivalent law of foreign country, including the US GILTI rules.
- (v) To respect the carefully designed hierarchy of interlocking rules that has been agreed internationally as part of Pillar 2, the proposed measure should not apply if:
  - the recipient of the relevant income is subject to a **Qualified DMTT** under a law of a foreign country;
  - the recipient of the relevant income is a Constituent Entity of a Group with an Ultimate Parent Entity or Intermediate Parent Entity that is subject to a **Qualified IIR** under a law of a foreign country or of Australia; or
  - the recipient of the relevant income is a Constituent Entity of a Group that includes at least one other Constituent Entity that is subject to a **Qualified UTPR** under a law of a foreign country or of Australia.

The defined terms for the purposes of (v) could be adopted from the GloBE Rules published by the OECD/G20 Inclusive Framework in December 2022.

In addition, we also submit:

---

<sup>14</sup> Subsection 832-725(1A) ITAA 1997 and Articles 4.2 & 10.1 of the Pillar 2 Model Rules

- (vi) In cases where the proposed measure applies, it should only apply to the extent that the intangible related component (as described above) is derived in a LCTJ.

## 2. Amount of Australian tax imposed in response

### Legislative proposal

The ED proposes complete disallowance of an Australian tax deduction for in-scope payments.<sup>15</sup> This would impose tax at 30% of a gross amount on the wrong entity, being the payer, where the relevant profits are attributable to the functions, assets and risks of another person, being a non-resident associate.<sup>16</sup>

The response imposes tax on the wrong person and indeed could impose tax on the wrong economic group where the relevant recipient is an associate but not a group member.

The response is disproportionate in that it imposes a blunt-instrument response (denial of deduction), irrespective of the level of tax that has been paid, and imposes an effective tax of 30% of the gross income.

### Specific concerns

#### The proposed measure may result in excessive taxation

The proposed measure will almost always result in excessive taxation or over taxation because it will impose Australian tax at 30% on relevant income derived in a LCTJ, regardless of any Australian WHT or foreign income taxes actually imposed on the income and regardless of the level of expenses incurred in earning the income.

The OECD's comments on the Pillar 2 Subject To Tax Rule (STTR) are of relevance in this regard. The STTR is a treaty-based rule that will allow a source country to impose a top-up withholding tax to the extent that specified base eroding payments (including royalties and other intangibles-related payments) are taxed at an adjusted nominal rate of less than 9% in the recipient country.

The OECD's Pillar 2 Blueprint states as follows (emphasis added):<sup>17</sup>

649. Given that the nominal tax rate trigger applies to the gross amount of the payment, on a transaction by transaction basis and does not allow for blending, the STTR might, in certain cases, give rise to the risk of over-taxation. This over-taxation could arise, for example, where a covered payment is made to an entity that is subject to tax at a nil rate but which has incurred expenses in deriving that income. In this case, applying the minimum ETR determined under the income inclusion and undertaxed payments rules to the gross amount of the payment when computing the top-up rate to be applied to that payment under the STTR would give rise to an effective tax rate above that minimum rate and could even give rise to taxation in excess of economic profit ...

650. The effect of the rule will be to allow the source jurisdiction to tax the gross amount of the payment up to an agreed minimum rate. That is, the payer jurisdiction would be able to impose a withholding tax on the covered payment at a rate that was equal to the difference between the minimum rate provided for under the STTR and the adjusted nominal tax rate applicable to the covered payment in the payee jurisdiction ... Having a lower trigger and top-up rate under the STTR would limit the risk of over-taxation and be intended to arrive at a net tax burden that is (after taking into account any tax levied on the gross amount of the payment) equal, or at least broadly similar, to the minimum effective rate under the income inclusion and undertaxed payments rules ...

The STTR and the proposed measure adopt different collection mechanisms (additional WHT v. denial of deductions), but the underlying policy concern is the same, i.e. base eroding payments that are insufficiently taxed in the recipient country. The proposed measure is far more severe, because it imposes an additional tax of 30% on the gross payment (ignoring expenses and any other applicable taxes). In contrast, for the reasons explained in the extracts above, the STTR only tops-up the WHT to create a minimum tax of 9% on the gross payment (ignoring expenses but taking into account the base rate of WHT and corporate tax payable by the recipient).

---

<sup>15</sup> Section 26-110(2)

<sup>16</sup> Section 960-258

<sup>17</sup> Tax Challenges Arising from Digitalisation – Report on Pillar 2 Blueprint, OECD October 2020

## The proposed measure taxes the payer on the recipient's profits, which may create difficulties in payment

Due to the adoption of a full denial of deduction approach, the proposed measure may create difficulties in payment.

The example given in the draft EM is of an inbound distributor of tangible goods. We note that ATO PCG 2019/1 provides indicative profit markers for various kinds of inbound distributors. Based on PCG 2019/1, an EBIT margin (EBIT/Sales) of 5% would be an indicative mid-range outcome for a general distributor.

For illustrative purposes, if the proposed measure were to deny deductions for 10% or 15% of the cost of sales of such a distributor, the results would be as follows:

<b>Proportion of cost of sales denied</b>	<b>0%</b>	<b>10%</b>	<b>15%</b>
Sales	100.0	100.0	100.0
Cost of sales	(95.0)	(95.0)	(95.0)
EBIT	5.0	5.0	5.0
Tax	(1.5)	(4.4)	(5.8)
PAT	3.5	0.7	(0.8)
<b>EBIT margin (EBIT/Sales)</b>	<b>5%</b>	<b>5%</b>	<b>5%</b>
<b>ETR</b>	<b>30%</b>	<b>87%</b>	<b>116%</b>
<b>Tax computation</b>			
Sales	100.0	100.0	100.0
Deductible cost of sales	(95.0)	(85.5)	(80.8)
Taxable income	5.0	14.5	19.3
Tax payable	1.5	4.4	5.8

It can be seen that if 10% of the cost of sales is denied, the tax payable is almost 90% of the distributor's profits, and if 15% of the cost of sales is denied, the tax payable exceeds the distributor's profits.

Consequently, it may be difficult or impossible for the distributor to pay the tax that may result from application of the proposed measure, creating potential solvency issues.

## Submission points on amount of Australian tax that would be imposed

To address the above concerns, we submit that the amount of deductions denied by the proposed measure should be **sized so that it operates as a top-up tax**. That is, the amount of deduction denied would be the amount required to bring the total taxes imposed up to a sufficient minimum, after taking into account any Australian WHT and foreign income taxes already imposed on the relevant income.

For example:

- if the relevant income is already subject to Australian WHT at a rate of say 5%, the required top-up tax would be 10%, so the proposed measure should deny deduction for one third of the relevant portion of the payment; and
- if the relevant income is not subject to any Australian WHT or foreign income tax, the required top-up tax would be 15%, so the proposed measure should deny deductions for half of the relevant portion of the payment.

Full denial of deductions would be punitive and would result in imposition of Australian tax at 30% of the gross amount, well above the policy benchmark.

## 3. Scope of payments relating to intangible assets

### Legislative proposal

The ED proposes to disallow a deduction in respect of a payment made to an associate **to the extent** the payment is **attributable** to a right to **exploit** an **intangible asset**.<sup>18</sup>

The ED adopts a broad definition of exploit an intangible asset, which amongst other things includes 'use the intangible asset' and 'do anything else in respect of the intangible asset.'<sup>19</sup>

### Concerns

#### Breadth of in scope payments, and associated compliance

The ED at multiple points is drafted in such a way as to be exceedingly broad, and will require a large amount of work to test whether some part of a payment may relevantly be in scope. Consider each of the following tests, linkages and definitions:

- intangible asset
- related intangible asset
- exploit
- arrangement
- related arrangement
- to the extent
- attributable
- associate
- directly or indirectly
- results in

Even after an exhaustive analysis of the global supply chain, IP chain and tax structure of an organisation, it will often be very difficult to conclude that no part of a payment made by an Australian group member is in scope.

Consider the simplest of in scope cases:

- Ausco pays an amount to a non-resident associate in a LCTJ
- No part of the amount is a royalty
- There is currently no need to dissect the amount
- Some part of the payment may be in scope

It becomes necessary to apportion the payment as between the in scope non-royalty intangible related component and the balance. This effectively imposes a transfer pricing type analysis in respect of every in scope payment to apportion the payment, in circumstances where that is not presently required. All of the practical and compliance problems are compounded in real world facts which will be more complex than the above very simple example.

#### Mischaracterisation of amounts that are royalties

The EM when discussing the 'Context of the amendments' and 'Mischaracterisation'<sup>20</sup>, references behaviour involving the mischaracterisation of payments, and notes that:

---

<sup>18</sup> Section 26-110(2)

<sup>19</sup> Section 26-110(9)

<sup>20</sup> Paragraphs 1.11 to 1.16 & 1.37 to 1.40 of the draft Explanatory Memorandum.

- “SGEs may also mischaracterise payments that are in substance, but not legal form, made for the right or permission to exploit an intangible asset”<sup>21</sup>; and
- “the mischaracterisation ... typically results in royalty withholding tax not being paid”<sup>22</sup>.

As noted above, there are extensive existing provisions, with backstop provisions, to address cases of avoidance of Australian royalty WHT. This measure does not impose Australian royalty WHT, nor does it preclude the operation of provisions that can impose Australian royalty WHT: the application of the proposed measure as drafted can result in double Australian tax.

To the extent that a potential in scope payment is a royalty, it is submitted that the provisions related to Australian royalty WHT should be applied in the normal way. To the extent that the proposed measure has application having regard to the relevant conditions, as modified by our comments above in respect of the definition of LCTJ and the response being structured as a top up tax, the measure should take Australian royalty WHT into account in setting the amount of any denial. If for example, Australian royalty WHT was imposed at 15%, there is no further role for this rule.

### Genuine arrangements

The EM states ‘It is not intended for this anti-avoidance rule to inappropriately apply to genuine supply and distribution arrangements between associates, where there is no tax avoidance behaviour’.<sup>23</sup>

To assist taxpayers to understand the intended scope of the rule, which is exceptionally broad as drafted, we submit that the EM should contain detailed examples to better delineate out of scope genuine arrangements.

## 4. Other matters

### Penalties

The EM at paragraph 1.40 states, ‘To complement this anti-avoidance rule, a shortfall penalty provision is being considered as a punitive measure to penalise SGEs who mischaracterise such payment in an attempt to avoid income tax, including withholding tax’. We submit that proposed measure sufficiently penalises SGEs. No further penalty is warranted.

### Restructuring to comply with the proposed measure

It appears that one of the main objectives of the proposed measure is to deter multinationals from structuring their affairs such that intangibles-related income is earned in LCTJs.<sup>24</sup> Multinationals may therefore respond to the proposed measure by restructuring so that they no longer derive intangibles-related income in LCTJs.

We submit that such restructuring should not attract the operation of the general anti-avoidance provisions in Part IVA ITAA 1936, provided that the restructuring is straight-forward and consistent with the policy intent. Guidance in this respect should be provided in the Explanatory Memorandum or an appropriate ATO product.<sup>25</sup>

---

<sup>21</sup> Paragraph 1.11 of the draft Explanatory Memorandum

<sup>22</sup> Paragraph 1.13 of the draft Explanatory Memorandum

<sup>23</sup> Paragraph 1.47 of the draft Explanatory Memorandum

<sup>24</sup> E.g. paragraphs 1.10, 1.16 & 1.17 of the draft Explanatory Memorandum.

<sup>25</sup> E.g. see PCG 2018/7 on restructuring in response to the hybrid mismatch rules.