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28 April 2023

By email: MNETaxIntegrity@treasury.gov.au

Treasury Exposure Draft Legislation – Denying deductions for payments relating to intangible assets connected with low corporate tax jurisdictions

Dear Assistant Secretary

Ernst & Young (EY) welcomes the opportunity to respond to Treasury's exposure draft legislation on the integrity rule to deny deductions for payments relating to intangible assets connected with low corporate tax jurisdictions, released on 31 March 2023 (Integrity ED Bill).

We understand the Government's commitment to multinational tax avoidance and its desire to continue to strengthen Australia's tax system. Our fundamental response to the Integrity ED Bill is that Australia's tax laws are robust and its anti-avoidance provisions are sufficient to deal with many of the tax abuse issues associated with intangible payments. We believe Government and Treasury should reconsider the need for a far-reaching Integrity ED Bill and narrow the scope to non-treaty jurisdictions.

Noting this, we strongly urge Government and Treasury accept the recommendations and submissions in Appendix A. A summary of some of our key points are:

- The definition of "low corporate tax jurisdiction" is too broad and, inappropriately, does not have regard to:
 - Jurisdictions who adopt a Qualifying Minimum Top Up Tax (QDMTT) of 15% in accordance with the OECD Two Pillar Plan.
 - Jurisdictions who impose corporate income tax at multiple government levels.
- We strongly submit that Government and Treasury adopt a definition which excludes jurisdictions who adopt a QDMTT and that this is announced as part of the May 2023 Federal Budget.
- The definition of "low corporate tax jurisdiction" is too vague and has the potential to unintentionally include many jurisdictions.
- The law does not have an appropriate or apparent mechanism to target tax abuse and avoidance arrangements. This will impact organisations who are headquartered/parented in a defined "low corporate tax jurisdiction". This will also impact organisations who have sufficient economic substance in a defined "low corporate tax jurisdiction".
- The law does not go far enough in excluding tangible assets and genuine distribution arrangements.

- The start date should be amended to 1 January 2024 since:
 - It does not give organisations sufficient time to appropriately prepare for these rules relative to the impact of the rules.
 - It also does not give the Australian Taxation Office sufficient time to provide meaningful advice and guidance which is a key tenet of Australia's tax system.
 - We recommend the start date is pushed back to align with Australia's ultimate adoption of Pillar Two.
- There is no exclusion for payments which are already subject to Australia's tax regime through royalty withholding tax. It will therefore result in economic double taxation where payments, which are currently subject to royalty withholding tax, will be denied from deductibility.

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Should you have any questions in relation to the above or wish to discuss these matters in further detail, please do not hesitate to contact Sean Monahan (02 8295 6226, sean.monahan@au.ey.com) in our International Tax and Transactions practice or Alf Capito (02 8295 6473, alf.capito@au.ey.com) or Tony Merlo (03 8575 6412, tony.merlo@au.ey.com) in our Tax Policy Centre.

Yours sincerely

Ernst & Young

Appendix A

A.1 Policy Objective

The policy objective of the integrity rule is unclear. The draft EM explains that *"The amendments will complement Australia's existing anti-avoidance provisions to deter tax avoidance behaviours of SGEs who exploit intangible assets to derive income in a low corporate tax jurisdiction."*

However, the integrity rule does not contain any operative provisions which are aimed at 'tax avoidance behaviours'. Further, there is no tax avoidance purpose test, and the law does not consider the objective purpose of the arrangements. In that regard, it is unclear how the rule is aimed at deterring tax avoidance behaviours.

Furthermore, the draft law does not align with the previous announced policies related to the integrity rule. The draft EM explains that the *"amendments will deliver on part of the Government's multinational tax integrity package to address the tax avoidance practices of multinational enterprises as announced in the October 2022-23 Budget."* We note:

- In May 2019, as part of the Labor Party's election policies, Labor announced that it would *"stop multinationals from getting a tax deduction when they unfairly funnel royalty payments to arms of their own company that pose a multinational tax risk.... Multinationals can currently 'treaty shop' and potentially funnel intangibles...into tax havens like the Cayman Islands."* The election policy went on to further state *"A multinational can still get the tax deduction if the firm can substantiate to the Commissioner of Taxation that the royalty payments are not for the dominant purpose of tax avoidance."*
- As part of the 2022 election, Labor's policy on this issue was similar to the above and was titled *"Tax Havens Integrity"*. The Labor Party would *"limit the ability of large multinationals to abuse Australia's tax treaties while holding intellectual property in tax havens from 1 July 2023. A tax deduction would be denied for payments for the use of intellectual property when they are paid to a jurisdiction where they don't pay sufficient tax. This measure...is related to measures put in place in the UK, US and Netherlands."*

It is clear that the current scope of the draft law is broader than as announced as part of Labor's election policies. Our overarching comment in relation to the draft law is that should align with these policy announcements and should be restricted to tax havens only i.e. it should only apply to payments made to non-tax treaty jurisdictions.

We also note the comment referenced above that the law is intended to *"deter tax avoidance behaviours"*. Where legislative measures have a behavioural deterrence policy, it is generally relatively easy to identify the intended behavioural response. For example, when section 177DA of the 1936 Act (i.e. the Multinational Anti-Avoidance Law) was introduced, the intended behavioural response was apparent. It is not easy to identify the intended behavioural response of this proposed measure. Many organisations will not be able to undertake any behavioural response changes if this rule stays in its current form.

For completeness, we also refer to our previous submissions on the proposed policy of this integrity measure. We reiterate our previous comments that Australia has an existing robust anti-avoidance framework which should be sufficient to counter any integrity issues associated with intangibles

including the examples in the EM. This includes the Diverted Profits Tax which already addresses direct and indirect payments to low tax jurisdictions in tax avoidance situations.

A.2 Low Corporate Tax Jurisdiction – The 15% or Less Rate

The current draft law defines a low corporate tax jurisdiction as one where the lowest corporate income tax rate under the laws of the foreign country is less than 15% or nil.

The draft law should clearly state that a low corporate tax jurisdiction excludes jurisdictions who have, like Australia, committed to adopting the OECD's global minimum tax rate of 15% pursuant to the OECD's Two Pillar Plan. This should be the case even if that jurisdiction does not adjust its headline corporate income tax rate.

Given the draft law only applies to SGE's, these organisations will be subject to a global minimum tax of 15% (even in jurisdictions which do not adjust the headline corporate income tax rate). For example, Ireland has announced that it will adopt a Qualifying Minimum Domestic Top-up Tax (QDMTT) of 15% from 1 January 2024 albeit its headline rate of 12.5% will not be adjusted. We also note that Switzerland is also likely to adopt a QDMTT from 1 January 2024.

If the draft law is not intended to exclude jurisdictions which will adopt a QDMTT (but continue to have a headline rate of less than 15%), we urge an urgent review of the draft law as contrary to Australia's commitment to the OECD's Two Pillar Plan.

Further, a change to the definition to include QDMTT jurisdictions should be announced as soon as possible and not as part of the final bill. The May 2023 Federal Budget provides Government with an excellent opportunity to include this announcement.

Low Corporate Tax Jurisdiction – National Level Rate

The draft EM states that *"only national level corporate tax is relevant for determining whether a foreign country is a low corporate tax jurisdiction."*

Further clarity is required in relation to the scope of "national level corporate tax". In particular, whether this is intended to only be a single national level corporate tax rate or whether the rule allows for the consideration of corporate tax applied at more than one level of government.

A specific example of a jurisdiction which imposes corporate taxation at more than one level is Switzerland. The Convention between Australia and the Swiss Confederation for the Avoidance of Double Taxation with respect to Taxes on Income, with Protocol (the "Swiss/Australia DTA") considers that Swiss taxation includes taxes imposed by its subdivisions and local authorities. These layers of taxation are known as cantonal or communal taxes and are specifically included in the Swiss/Australia DTA definition of "Swiss Tax".

If the draft law is not intended to include additional layers of corporate taxation in a foreign jurisdiction, then there is a high possibility that SGE's who are subject to corporate taxation at more than a 15% rate will be in scope. This is clearly an unintended consequence. It will also mean that payments to countries like Switzerland will be in scope. This would produce an absurd outcome given we not only have a DTA with Switzerland, but it is a DTA based on a "most favoured nation" status.

In that regard, precedent can be found in the hybrid mismatch rules in Division 832 of the Income Tax Assessment Act 1997 (ITAA 1997) and the specific inclusion of state and municipal taxes when

applying the hybrid mismatch integrity rule and determining whether foreign income tax has been imposed on a payment in a foreign jurisdiction at a rate of 10% or more. We suggest that guidance be obtained from this integrity provision and we see no logical reason why such taxes should be taken into account for the hybrid mismatch rules but yet ignored for the intangibles regime. Indeed, there seems to be an obvious inconsistency in the Australia's tax rules if this were to be the case.

We also refer to the foreign income tax offset rules in Division 770 of the ITAA 1997. "Foreign income tax" is defined in section 770-15 as a 'tax on income' and therefore includes additional layers of taxation if imposed by foreign jurisdictions. We also suggest that guidance be obtained from the definition of foreign income tax in Division 770.

Low Corporate Tax Jurisdiction- Interpretation of proposed paragraphs 960-258(2)(d) and (e)

Proposed subsection 960-258(1) outlines the definition of a low corporate tax jurisdiction and proposed paragraph 960-258(1)(a) states that this will be a country where the rate of corporate income tax is less than 15% (or nil). Subsection 960-258(2) outlines further matters relevant to the determination of the corporate income tax rate under proposed paragraph 960-258(1)(a).

Paragraph 960-258(2)(d) states "*if, under those laws, there is no income tax on a particular amount of income – treat the rate of income tax on that amount as being nil*". Proposed paragraph 960-258(2)(e) then states "*if, under those laws and applying paragraphs (a) to (d), there are different rates of income tax for different types of income – have regard only to the lowest rate.*"

The combined effect of these paragraphs is that if a jurisdiction has either:

- A different rate of income tax for a different type of income which is lower than 15%; or
- No income tax on a particular amount of income.

then the lowest of these rates will be considered the "rate of corporate income tax" for the purposes of proposed paragraph 960-258(1)(a). This is regardless of whether the particular rate applies to the organisation or whether the organisation has any income which may be subject to a different rate of income tax than the headline rate.

It is unclear whether the scope of these paragraphs is as intended as it will likely capture many jurisdictions which are not considered low corporate tax jurisdictions and which should not be captured under the policy of the rules. For example:

- New Zealand has a 28% headline corporate tax rate. New Zealand does not impose income tax on capital gains. Therefore, for the purposes of paragraph 960-258(2)(d), the rate of income tax on that amount will be nil. Paragraph 960-258(2)(e) will then have regard to the lowest rate and, for the purposes of paragraph 960-258(1)(a), New Zealand will be considered to have a rate of corporate income tax of zero.
- Many jurisdictions have a participation exemption for dividends. While proposed paragraph 960-258(2)(a) allows for the disregarding of "concessions for intra-group dividends", many participation exemptions (including Australia's) would not be characterised as a "concession for intra-group dividends" given they apply to dividends and/or capital gains which are not likely to be considered "intra-group" as there is no 100% ownership requirement. Similarly to the above example, where a general participation exemption exists, paragraph 960-258(2)(d) will designate a zero rate of income tax and paragraph 960-258(2)(e) will take the lowest rate (being nil).

We recommend that Treasury consider the policy purpose and objective of proposed paragraphs 960-258(2)(d) and (e) as there is a high risk that they will produce unintended consequences. We recommend that these paragraphs be deleted from the proposed law and the headline rate be considered the relevant rate.

Alternatively, we recommend that, where a lower rate of tax exists on a particular amount of income, that lower rate is not to be taken into account if the organisation (and/or the relevant payments which are the subject of the rule) is subject to tax at the national corporate tax rate.

Low Corporate Tax Jurisdiction – Further Comments

Greater Certainty

As the proposed law applies to payments made after a particular date, a date which is imminent, organisations should be entitled to absolute certainty as to which jurisdictions are in scope. Given the comments made above in relation to the 15% rate, the consideration of multiple levels of taxations, and the uncertainty as to how the provisions should be interpreted, the draft EM should be adjusted to remove any uncertainty as to which jurisdictions are in scope.

This could easily be achieved by including a list of jurisdictions which the law is clearly intended to apply to. This list can be adjusted and amended through regulation making power.

We submit that as the application of the rule is to deny a deduction, there should be no uncertainty as to its application. We further note that the provisions in Division 26 of the 1997 Act are very clear as to their application. Proposed section 26-110 should be no different in its clarity and certainty.

A.3 Preferential Patent Box Regimes

The process by which the Minister can determine a foreign patent box regime falls within the scope of the draft law is unclear.

Given the destabilising nature of unilateral actions, the ability for the Minister to make such a determination should be restricted to circumstances where the OECD has reached a decision that a practice is harmful.

We also recommend that where a determination is made by the Minister, that it applies only if the organisation (and/or the payments) is taking advantage of the regime in relation to the payments made by the Australian entity. It would seem anomalous for the Minister to designate a 'country' as a low corporate tax jurisdiction because it has a preferential patent box regime, in circumstances where the organisation is not utilising the regime or the payment made by the Australian entity does not benefit from the regime. This would potentially deny a deduction in circumstances where the rate of tax applicable to the multinational entity and/or the payment could still be 15% or more.

We also note that there is no requirement in the law for the preferential patent box regime to have a minimum rate of tax. There may be circumstances where the patent box regime has a tax rate that is 15% or more. We recommend that the Minister's power be limited to patent box regimes without sufficient economic substance where the tax rate imposed is less than 15%.

As a comment, we also note that there may well be circumstances where the substance in a patent box regime (in general) is less than the substance in some of the jurisdictions which may be caught under paragraph 960-258(1)(a). This may include where the organisation is headquartered in a

particular jurisdiction or have significant economic substance (with no patent box). It would seem an anomalous outcome, and again contrary to policy, that the rule may apply to a jurisdiction which entails more substance than general patent box regimes. This is further support for the comments below in relation to scope and carve outs.

A.4 Proposed Start Date

We refer to the proposed start of 1 July 2023. Given the draft law applies to payments made after this date, we urge the consideration of a delay to the start date.

Unlike the vast majority of Australia's tax laws, which apply to income years commencing on or after a particular date, the draft law is intended to apply to any payments made after 1 July 2023. Given the draft law was released in early April 2023 and submissions are due on 28 April 2023, there is clearly insufficient time for organisations to give proper regard to the impact of these rules.

This will be exacerbated if the comments above in relation to the definition of low corporate tax jurisdiction are not accepted by Treasury and countries like Ireland and Switzerland remain in scope.

Given the majority of OECD members have committed to adopting the 15% global minimum tax and many will do so from 1 January 2024, it would make sense to delay the introduction of the draft law to align with 1 January 2024. This will give organisations additional time to prepare for the draft law.

We note this additional time will also allow the Commissioner of Taxation and the Australian Taxation Office to have sufficient time to prepare and publish advice and guidance on the draft law.

An additional option for Government is to keep the start date, but also include a section that excludes payments made after the start date where the jurisdiction has announced that a QDMTT will be implemented prior to 30 June 2024.

A.5 Clarity on Scope

Carve-Out/Exclusion

The draft law as currently drafted would have a very broad scope and would impact on organisations which do not have arrangements with features of tax avoidance or tax avoidance behaviours.

This would include arrangements where payments are made to a low corporate tax jurisdiction as defined, but where the organisation is headquartered and parented in that jurisdiction.

At a minimum, there should be a carve out for parent level structures where the organisation is headquartered in a low corporate tax jurisdiction. These organisations are unable to undertake any actions to avoid being subject to the proposed rule.

There are various ways this can be achieved without compromising the policy of the integrity rule. This could be an explicit carve out or it could be through the use of an avoidance test.

For completeness, we note it would be completely contrary to Australia's approach to intangible development for these organisations to have to potentially restructure their global arrangements to comply with the rule. This would require moving or shifting intangibles and intellectual property away from their parent jurisdiction and away from the location of the development, enhancement,

management, protection and exploitation of the intangibles. This is contrary to Australia's own tax rules and the OECD principles to which Australia has subscribed.

A.6 Royalty Withholding Tax – Exclusion or Compensating Adjustment

The law does not provide a carve out for payments which may be currently recognised as royalties and subject to royalty withholding tax, either under the domestic provisions or under a royalty article of a relevant double tax agreement.

Given the draft law's focus on payments for intangibles, there will be scenarios where organisations are currently characterising payments as royalties and withholding and remitting tax to the ATO accordingly. It would seem contrary to the policy that payments (including parts of payments) which are treated as royalties and subject to the appropriate taxing mechanism would be caught under this draft law.

We recommend the law have a carve out for payments which are or have been subject to royalty withholding tax, especially a 30% rate.

We also note that the law could apply such that there are situations where royalty withholding tax has been remitted and a deduction is subsequently denied. This is economic double taxation and contrary to appropriate tax policy. In that regard there should be a compensating adjustment for withholding taxes.

We particularly note the ATO's draft ruling TR 2021/D4 in relation to software distribution arrangements. Pursuant to the ATO's view, payments made pursuant to certain software distribution arrangements are royalties. Those same payments will be subject to the integrity rule if the low corporate tax jurisdiction limb is met. In these scenarios, royalty withholding tax will be paid and yet the deduction denied.

A.7 Operative Provisions

Tangible Assets

While the draft EM is clear that it does not apply to tangible assets, we note that the draft law could be interpreted in a manner inconsistent with this intention. Proposed paragraph 26-110(7)(a) provides that the section does not apply to an intangible asset that is... 'a right in respect of, or an interest in, a tangible asset.' This does not however specifically exclude a "tangible asset" from the ambit of the section as 'a right in respect of, or an interest in, a tangible asset' is not the tangible asset itself, but rather a right in the asset. We recommend that this is made clearer by specifically include a sub-paragraph which states "a tangible asset".

Given the definition of "arrangements" and the scope of the concept of "as a result of", it is still possible that genuine distribution arrangements of tangible goods may be inadvertently captured by the law. For example, where a trademark owned by an Australian entity's associate is used in marketing collateral and/or storefronts operated by the Australian entity. The draft EM creates uncertainty for tangible assets given:

- Paragraph 1.47 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*"

- Yet Example 1.1 is an example focussed on tangible assets where the integrity rule still applies to intangible asset exploitation.

Given there is no tax avoidance test or an objective behavioural test, there is uncertainty as to how it can be ensured that the rule not inappropriately apply to genuine supply and distribution arrangements.

In that regard we recommend that, at the very least, an example be included where the proposed rule does not apply where payments are made for tangible assets and there is incidental use of intangible assets for sales and marketing purposes such as marketing material, advertisement, promotion and sales activities. The overwhelming majority of tangible assets have some sort of embedded intangibles (e.g., trademark, patent, design, copyright) and there must be a sensible approach to excluding incidental use which does undermine the integrity of the rule. At its stands, the draft law struggles to distinguish between a payment for a tangible asset (which has embedded intangibles) and a payment for the exploitation of the exact same asset. While this is primarily because 'exploitation' is drafted so broadly, the compliance impact on genuine distributors cannot be underestimated.

We further note that the guidance in both paragraph 1.47 and Example 1.1 can be expanded through further commentary to elaborate on the key features and takeaways of both paragraph 1.47 and Example 1.1. While paragraph 1.47 states that the rule is not intended to apply to genuine distribution arrangements where there is no 'mischaracterisation', in Example 1.1 there is a use of intangibles in the form of using trademarks on marketing materials and branded shopfronts where the Australian entity is making payments for the purchase of branded tangible goods as well as making management and service fee payments. On a reading of paragraph 1.47 and Example 1.1, we submit the following would not (and should not) be captured by the rule and the law and the draft EM should clearly state so:

- Payments where there is no mischaracterisation as the payment is only for the purchase of tangible goods (with embedded intangibles) where there are no separate management and service fee payments i.e., payments are only made for tangible goods and there are no other payments between associates which could be subject to mischaracterisation.
- Payments where there is only an incidental use of an intangible asset for the purposes of carrying out distribution activities, as outlined in TA 2018/1.1 In that regard incidental use could be defined as per TA 2018/1 and should cover circumstances where:
 - The Australian entity is selling a tangible asset;
 - Only minor steps are required to bring the product to a finished/sellable state i.e. packaging/boxing/labelling; and
 - Marketing and sales resources are used by the Australian entity to undertake its distribution activities.

We note that clarifying these two points would ensure genuine supply and distributions arrangements of tangibles are not inadvertently caught and would alleviate the otherwise significant compliance burden for a very large number of taxpayers. As mentioned above this could be achieved through

¹ TA 2018/1 states "incidental use of an intangible asset...for example, this alert does not apply to 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."

additional commentary and additional examples of genuine arrangements as well as clarity on 'mischaracterisation' and the scope of exploitation in so far as it relates to tangible assets.

We note that lack of clarity on the scope of the tangible good exception will particularly impact industries with significant intangible assets, but a tangible good product base, including life-sciences, fast moving consumer goods, consumer electronics and automotive industries. The draft law is clearly not intended to apply to the purchase of these goods but it leaves open a significant level of uncertainty for SGEs in these industries. Ongoing uncertainty as to the scope of this rule to genuine distribution arrangements of tangible goods will be disruptive and create unacceptable uncertainty for organisations.

Finally, we note that this area would be suitable to ATO guidance, including practical compliance guidance, noting that the imminent start date will be an issue for timely ATO advice.

Payments

The rules are intended to apply where payments are made directly or indirectly through one or more other entities.

This will require organisations to trace beyond the immediate recipient of a payment and it will not be sufficient that the immediate recipient is not in a low corporate tax jurisdiction.

In addition to imposing significant compliance burdens on organisations, the policy rationale of requiring an indirect payments rule is unclear. An indirect tracing rule is incredibly onerous and complex for both taxpayer and tax authority alike. Given that the intent of the rules is to ensure that the payment flow from Australia is subject to a general 15% rate, we suggest that a carve out from the indirect tracing rule should be available provided a taxpayer group can demonstrate that the relevant entities in the intangibles supply chain are subject to a minimum corporate statutory rate - including local and municipal taxes, and/or CFC/Sub part F equivalent taxes, and or Pillar two minimum taxes of 15%. This way the actual flow of funds need not be traced, but only an assessment of the likely entities in the supply chain.

We also note that including a de minimis rule would be greatly beneficial from a compliance perspective without compromising the integrity of the proposed rule. This could be a rule which is similar to the Diverted Profits Tax "\$25 million income test".

Given the significant compliance burdens, clarity from the ATO in the form of advice of guidance on the scope of indirect 'payments' will be necessary to assist organisations in ensuring they can comply with the rules.

Arrangements

The scope of an arrangement or related arrangement is very broad. Further the draft EM makes it clear that the concept of "*as a result of*" the arrangement is also intended to be extremely broad.

Given the draft EM explicitly acknowledges that the payment and the exploitation does not need to be provided in the same contract, further guidance should be outlined in the EM to assist in organisations in appropriately considering the application of the rule. In that regard, further detailed examples of the types of arrangements intended to be captured under the draft law would assist. The existing sole example does not provide sufficient guidance as to the intended scope of 'arrangements'.

We note that this area would be suitable for ATO advice and guidance given its broad scope.

Exploitation

The draft law explains that the concept of exploitation is designed to be extremely broad and effectively includes “*doing anything...in respect of the intangible asset.*” In addition to exploitation, the rule applies to the permission to exploit an intangible asset as defined.

As noted above, the proposed definition is too broad when applied to genuine distribution arrangements of tangible assets. We suggest an incidental use exception be included in the definition of exploitation, for tangible assets.

Given the concepts of exploitation and permission to exploit an intangible asset are so broad and are used such in an integrity rule, further examples as to how these terms are to be practically applied and interpreted should be provided. In the absence of additional examples, the broad scope of the language could be subject to significant misinterpretation.

We specifically note that the broad definition may also inadvertently capture arrangements which do not necessarily involve the ‘exploitation’ (as it is generally understood) of intangible assets as well as genuine service arrangements. By way of example:

- A global group may enter into an agreement with a global customer for the provision of services globally. The customer has subsidiaries in multiple jurisdictions and the global group has affiliates in multiple jurisdictions. The agreement is for the provision of services and requires the global group to enter into service arrangements with its subsidiaries to deliver on the agreement with the global customer. While the entire arrangement is aimed at the provision of services, the scope of exploitation means these types of arrangements might be inadvertently in scope. This is further complicated by the difficulty in distinguishing between a payment for services and a payment for a royalty/intangible (note the ATO’s IT 2660 ruling and the challenge of distinguishing the two). We recommend services be specifically excluded.
- A global group creates software for the purposes of internal use by its global subsidiaries. The software is not marketed and distributed and is an internal software system. Global subsidiaries are charged a fee to either use the software or a fee as part of the ongoing cost sharing associated with the maintenance of the software. We recommend internal use be excluded.
- A global group offers services to investment funds. A key asset of the group is software technology which helps deliver services to its clients. The group does not sell the software to customers. The development costs of the software are pooled and recharged to subsidiaries globally given the software is developed for the benefit of the global group. These pooled costs often include a large proportion of third-party costs. We recommend that recharges and other cost sharing arrangements which reflect genuine pooled costs should be excluded.

We note that this area would be suitable for ATO advice and guidance given its broad scope.

Attributable

The rules require an assessment of the extent to which a payment is ‘attributable’ to the right to exploit an intangible asset. This contemplates apportionment in circumstances where the payment is attributable to other rights or things.

The example in the draft EM also contemplates an apportionment but provides no guidance as to how such an exercise could be undertaken. Given the uncertainty of an apportionment exercise and the lack of guidance as to how to apportion payments between multiple rights and things, further guidance through commentary and examples would be necessary.

We note that the concept of attribution should have specific regard to the arm's length principle and reference should be made to the use of the arm's length principle as a way to determine whether an amount is attributable to the right to exploit an intangible asset. This would align the attribution with the OECD Transfer Pricing guidelines and apportion payments to intangibles that third parties would pay for.

'Deduct ... an amount for a payment'

The draft law seeks to stop a taxpayer from deducting an amount for a payment in general terms in paragraph 26-110(2), without specifying the kinds of deductions it is applicable to.

The scope set out in paragraph 26-110(2)(b) may include intangible assets the payment for which is not deductible under section 8-1 where, for example, it is capital in nature. Instead, the decline in value of the relevant asset, which does not necessarily have an express nexus to a particular payment, is deductible under, for example, subdivision 40-B.

The draft law should clarify that it only applies to section 8-1 deductions.

A.8 Treaty Interactions

Given there is no general exemption or carve out for payments made to treaty jurisdictions (which we submit above is contrary to the policy of the rule), there are also treaty interactions and issues which arise.

Several of Australia's double tax agreements include a non-discrimination article which is aimed at ensuring payments are deductible under the same conditions as if they had been paid to a resident of Australia. Denying a payment to a jurisdiction where such a clause exists would be contrary to Australia's treaty obligations. Australia should continue to put as much effort as possible in respecting its treaty obligations.

Given the payments are made between associates, denying a deduction for payments made to an associated enterprise (under the associated enterprises articles of the treaties) could also be contrary to Australia's treaty obligations. Given these payments will be arm's length payments, denying deductions would not align to the associated enterprises articles.

A.9 Penalties - Paragraph 1.40 of the Draft EM

We note that paragraph 1.40 of the draft EM contemplates the introduction of a punitive shortfall penalty provision to penalise SGEs who mischaracterise payments in an attempt to avoid income tax, including withholding tax. The draft EM requests the seeking of stakeholder views on this proposed penalty.

It is unclear whether those views are to be sought in this submission, given the draft EM does not contain a draft law associated with this proposed shortfall penalty. However, we provide some views on this proposal below.

We note that the existing SGE penalty regime is comprehensive and entitles the Commissioner of Taxation to apply various levels of penalties, with SGE multipliers, depending on the nature of the shortfall giving rise to the penalty. In certain circumstances, where the Commissioner concludes that an SGE has been reckless, the penalty can be 100% of the shortfall tax liability. Further, where the Commissioner concludes that an SGE has intentionally disregarded the law, the penalty can be 150% of the shortfall tax liability. These are significant penalties which can apply to SGEs and in that regard it is unclear why an additional penalty would be required in circumstances where the existing regime is so comprehensive, and punitive.

We also note that there are also penalties for failing to withhold and remit withholding tax to the Commissioner in circumstances where there is an obligation to do so. A payment which is a royalty, and to which the payer has not withheld and remitted to the Commissioner, can result in the payer being denied a deduction for the payment. Given this existing penalty, it is also unclear why an additional penalty would be required.