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The Ashurst logo, featuring the word "ashurst" in a lowercase, bold, sans-serif typeface.

Dear Corporate and International Tax Division

1. INTRODUCTION

Thank you for the opportunity to provide comments on the exposure draft legislation *Treasury Laws Amendments (Measures for Consultation) Bill 2023: Deductions for payments relating to intangible assets connected with low corporate tax jurisdictions (Exposure Draft)*.

Ashurst is a leading global law firm and in Australia (formerly known as Blake Dawson) is one of Australia's largest law firms. The Ashurst tax practice is one of the largest tax practices among the law firms. Ashurst advises clients across all industry sectors, including ASX-listed companies, large multinationals, private companies, funds, financial institutions, and governments.

This letter sets out our submissions covering key policy and drafting issues identified in relation to the Exposure Draft (**Submission**).

Section references below are to the *Income Tax Assessment Act 1997 (ITAA 1997)*, *Income Tax Assessment Act 1936 (ITAA 1936)* or to the Exposure Draft. We have also referred to the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022 (OECD TP Guidelines)* and *OECD Commentaries on the Articles of the Model Tax Convention (OECD Commentary)*.

We would like the opportunity to discuss our submission points further with Treasury once you have had the opportunity to review.

2. GENERAL

In our Submission on 6 September 2022 in response to the *Consultation Paper – Government election commitments: Multinational integrity and enhanced tax transparency*, we raised a number of concerns as to why the proposed new law was unnecessary, particularly given that the arrangements are already dealt with by other specific tax regimes such as the transfer pricing and general anti-avoidance provisions.

Furthermore, the proposed new rules do not appear to be aligned with (and in particular, appear to go beyond) any particular OECD Base Erosion and Profit Shifting (**BEPS**) initiatives. As such, if not drafted and considered carefully, or administered properly, this measure represents a real risk of adversely impacting foreign investment in Australia. In addition, with the anticipated adoption of the OECD's Pillar Two rules, this proposed measure may be adversely viewed as Australia asserting primary taxing rights (by denying deductions) over low or concessionally taxed income and as such could be seen as a unilateral measure which goes against the internationally agreed approach amongst the OECD Inclusive Framework.

Australian businesses may generally enter into intangibles / IP arrangements to enhance their operations in Australia. In certain circumstances, businesses may not have control over the location of the intangibles they license and under the proposed measure may bear significant cost where they are not able to deduct the commercial expense paid.

Further, adopting the proposed legislation in its extremely broad form without a 'purpose' element (consistent with other anti-avoidance provisions) is likely to disincentivise foreign investment and developments in Australia, by increasing the potential cost for companies (in the form of denial of deductions), thereby reducing their competitiveness.

In particular, for the reasons set out in the following sections of this Submission, the broad and results-based approach adopted by the Exposure Draft (without reference to tax avoidance behaviours) will pose a significant risk for SGEs given ordinary commercial arrangements may be inadvertently brought into scope of the measure. That is, there is a genuine risk that the rules may apply even in circumstances where the relevant payments are at arm's length and there is sufficient economic substance in the jurisdiction of the ultimate owner of the intangible asset.

The use of "intangible asset" as a basis for effectively levying Australian tax is out of step with the treatment of these assets under the double tax treaties. If there is a payment attributable to use of an intangible asset that falls within the definition of "royalty", then it is properly and should already be subject to Australian tax but, the denial of that deduction in addition to withholding tax is not in

line with the international tax ecosystem and how royalties are taxed. This creates a punitively high tax impost on these arrangements.

In addition, if the payment for the use of the intangible asset is not characterised as a "royalty", prima facie Australia has no taxing right over this (as there is no royalty withholding tax). However, by denying the deduction Australia is effectively imposing a 30% tax on the payment. This extends Australia's scope of tax beyond that agreed in double tax treaties, and in effect subjects income not properly within the Australian tax net to a 30% tax.

While we remain of this view, we understand that the proposed measures will be proceeding and our Submission is therefore targeted at ensuring the Exposure Draft is refined and clarified so that it operates in a manner that appropriately balances the Government's interests without unduly burdening taxpayers.

3. DETAILED COMMENTARY ON KEY POLICY ISSUES

No 'Purpose' Requirement

The announcement by the Labor Party in 2019 that set out the proposed policy measure for multinationals "paying their fair share of tax" indicated that this policy measure was only intended to apply if a taxpayer had a purpose of avoiding Australian tax,

*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**.*

[Emphasis added]

Further, the stated aim in the Explanatory Memorandum (at paragraph 1.5) is that:

*[t]hese 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.*

[Emphasis added]

Given the context of its introduction and the overarching anti-avoidance focus of this measure, it is somewhat surprising that the measure does not require an anti-avoidance 'purpose' to be satisfied, in order for it to apply. Rather, the Exposure Draft adopts a 'results' based test, i.e., under paragraph 26-110(2)(b), as a result of the arrangement under which you make the payment...; and under paragraph 26-110(2)(c), the acquisition of the right to exploit the intangible or the exploitation of the intangible asset results in the recipient or another associate of yours deriving income in a low corporate tax jurisdiction.

General anti-avoidance tax laws rely on some form of purpose test that requires a link between a particular arrangement and the avoidance of a jurisdiction's tax. In our view, absent a purposive requirement in the proposed measure found in other anti-avoidance provisions (whether sole, principal, dominant), the measure could conceivably apply to a much broader range of arrangements than intended, potentially including those with genuine commercial and economic substance and without a tax avoidance motive, thus creating further uncertainty and compliance complexity for taxpayers.

As noted in the Explanatory Memorandum at paragraph 1.47:

*[i]t 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.***

[Emphasis added]

However, the only carve-out provided is in the form of paragraph 26-110(7)(a), which applies by excluding an intangible asset that is a right in respect of, or an interest in, a tangible asset. The Explanatory Memorandum goes on to note that this exception is intended only to apply to arrangements that effectively do not go beyond the 'mere marketing and selling of finished goods'.

It is difficult to envisage the above exception being of relevant and sufficient application to all kinds of commercial arrangements across different industries and, importantly, it does not allow for the consideration or identification of tax avoidance behaviour (if any).

In order to achieve the stated aim in the Explanatory Memorandum to ensure the measure does not inappropriately apply to genuine arrangements, we submit that the introduction and inclusion of a 'purpose' test would assist in limiting the inappropriate operation of the measure. This will also ensure that the application of this anti-avoidance rule aligns with other anti-avoidance measures in the ITAA (e.g., Part IVA, Diverted Profits Tax), and the existing case law relating to the interpretation of relevant purpose tests will provide taxpayers with an appropriate level of certainty for this integrity measure.

Meaning of 'Intangible Asset'

As noted in the Explanatory Memorandum, the term 'intangible asset' is used in numerous provisions in the ITAA 1997, however, as it is an undefined term, it takes on the ordinary meaning of that term for the purposes of those provisions.

Identification of Intangible Assets

The Exposure Draft extends beyond the ordinary meaning for the purposes of identifying relevant intangible assets the payments which would be covered by this measure, by applying in the same way in relation to certain things referred to under the definition of 'royalty' in subsection 6(1) of the ITAA 1936. However, in our view, the manner of the present drafting and Explanatory Memorandum commentary is too broad and does not provide sufficient guidance to assist taxpayers in *identifying* appropriate arrangements.

For example, items of intangible assets are first provided by way of an example under paragraph 26-110(2)(c). This is then supplemented under subsection 26-110(5) (to effectively bring into scope certain intangibles relevant for the purposes of the 'royalty' definition under subsection 6(1), as well as to include anything that is a right in respect of, or an interest in, an intangible asset). The Explanatory Memorandum sets out some further examples of intangibles assets noting that they are intended to fall within the operation of the proposed measure,

whether or not they are already captured within the ordinary meaning of 'intangible asset'

[emphasis added]

However, aside from listing types of in-scope intangible assets, there is no additional commentary or guiding principles in the Explanatory Memorandum from which taxpayers are able to discern the rationale or assess for commonality across the listed assets (e.g., whether they are assets of a proprietary nature and/or contain proprietary right), to assist in applying that interpretation to their own arrangements.

Given the evolving nature of intangible assets, we submit that to the extent the legislative intent is to extend beyond the ordinary meaning of the term (as stated in the Explanatory Memorandum), the Exposure Draft should provide clear parameters to *identify* potential in-scope arrangements (rather than relying on simple references to *types* of assets identified across both the legislation itself and the Explanatory Memorandum). Further, the Explanatory Memorandum and the Exposure Draft should provide clear guiding principles that should underpin any process of analysis and identification of intangible assets.

In particular, we note that the core guidance provisions for the purposes of determining arm's length transactions under Australia's transfer pricing rules (specifically section 815-20 and section 815-135 of the ITAA 1997) make clear that regard should be had to the OECD TP Guidelines. That is, Australia's transfer pricing legislation is generally expected to be interpreted to achieve consistency with the OECD TP Guidelines.

It is generally accepted that the link between transfer pricing and intangible arrangements arises from the value that intangibles can bring to multinationals and the potential for profit shifting to

occur through cross-border transactions involving intangibles. Given the interconnectedness between transfer pricing and intangibles, we submit that the Explanatory Memorandum should provide guiding principles similar to those provided under Chapter VI of the OECD TP Guidelines, which stipulates that the identification of intangibles as a critical step in the transfer pricing analysis of transactions involving intangibles. In our view, this will not only provide more certainty to taxpayers in complying with the measure, but also ensure the measure is administered in a globally accepted and consistent manner within OECD frameworks.

Lastly, it is curious to note that under the Ministerial discretion in subsection 960-258(4) to determine additional foreign countries as low corporate tax jurisdiction as a result of preferential patent box regimes, it is explicitly noted that regard should be had to relevant OECD findings, determinations, advice, reports or other publications. This further strengthens our view that in providing further guidance on the identification of intangible assets, regard should be had to relevant OECD publications, such as the OECD TP Guidelines in this case.

Presence of Proprietary Rights

We note that both the Exposure Draft and Explanatory Memorandum make reference to data and access to customer databases are relevant intangible assets for the purposes of the measure.

Relevantly, the High Court decision in *Breen v Williams*¹ clarified that under Australian law there is no general proprietary right in information or data. While *Breen* specifically dealt with medical records, the principle could potentially be applied to other contexts where information is held by third parties.

Further, under Chapter VI of the OECD TP Guidelines, in the illustrations of items often considered in transfer pricing analyses involving intangibles, there are numerous references to the proprietary nature of those items (whether in the form of rights, know-how or database / compilations). That is, the inherent value of an intangible should largely stem from the proprietary nature of the relevant asset, for which value must be transferred for the right to use such an asset. Therefore, to the extent it has been decided that there is no general proprietary right in information or data (per *Breen*), further clarification is required as to in what circumstances payments for data and customer databases should be considered within the scope of this measure.

Accordingly, we submit that the Exposure Draft and Explanatory Memorandum be amended to limit the application of the measure to *certain* data and customer databases (and it should be made clear what types of arrangements involving data and customer databases the Government is particularly concerned with), as under the present drafting, in principle, *all* payments for data and customer

¹ (1996) 186 CLR 71.

databases to a 'low corporate tax jurisdiction' (absent a 'purpose' or 'motive' test), where there may be little or no proprietary right conferred, could nonetheless fall within the operation of this measure.

Royalty Arrangements

As will be covered later in this Submission, our view is that to the extent a payment is already subject to Australian withholding tax (or as an alternative, a minimum level of Australian withholding tax), the proposed measure should not apply to deny the Australian payer a deduction. This is on the basis that the appropriate amount of tax (e.g., the royalty withholding tax collected at source) has been paid in Australia in respect of the arrangement. Otherwise, companies risk a significant and disproportionately high tax impost on royalty arrangements, where no tax avoidance behaviour may exist at all, thereby unduly hindering the commercial competitiveness of relevant taxpayers.

On this basis, arguably there is no specific need to include within paragraph 26-110(5)(a) certain items mentioned under the definition of 'royalty' under subsection 6(1) of the ITAA 1936, for the purposes of denying a deduction on payments in respect of these items. This is because, in respect of royalty arrangements, the ITAA already contains an integrity measure which denies the payer a deduction to the extent royalty withholding tax has not been paid. We submit that the application of the proposed measure to royalty arrangements, in addition to subsection 26-25(1) of the ITAA 1997, is excessive and unnecessary and may result in uneconomic outcomes for taxpayers (covered in more detail later in this Submission).

Carve-out for tangible assets

Broadly, the proposed measure does not apply to tangible assets. In particular, there is a carve-out under paragraph 26-110(7)(a) for an intangible asset that is a right in respect of, or an interest in, a tangible asset. However, there could be potential uncertainty as to how this carve-out would apply on the basis of the explanation provide in the Explanatory Memorandum.

Under Example 1.1 of the Explanatory Memorandum, Blue Co (an Australian reseller of clothing and shoes) is considered to have exploited the trademark (owned by an associate in a low tax jurisdiction) and sub-license acquired in branding its shops and in marketing materials. Consequently the deduction for Blue Co is denied.

This should be contrasted with paragraph 1.47 of the Explanatory Memorandum which states that:

...trademarks printed on finished goods that are marketed and sold by an SGE to customers, without payments to an associate being mischaracterised or being effectively for the use of that trademark in the SGE's business beyond the mere marketing and selling of those finished goods, would be unlikely to attract the operation of this anti-avoidance rule.

In our view, there is insufficient commentary to assist in clearly distinguishing the examples noted above (which may result in disputes in administration) and in what instances an SGE's business may be considered to be 'beyond the mere marketing and selling of finished goods'. In particular, in contrasting the two examples above, should the starting presumption be that, where branding extends beyond the particular items or goods sold, then the proposed measure is expected to have application (or some other indicia)? It would be prudent for the Government to provide more guidance and examples in order to illustrate the full risk spectrum being considered in respect of this exception for in-scope arrangements.

Related arrangements

The proposed measure applies to payments made to an associate by an SGE, as a result of an arrangement, or a related arrangement, to the extent that payment is attributable to a right to exploit an intangible asset.

The term 'arrangement' refers to the existing definition of that term under subsection 995-1(1) of the ITAA 1997. This is already a very broad definition and will include not just the ordinary meaning or arrangement but also an agreement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings. In this regard, the Explanatory Memorandum notes that an objective test is required to examine the whole of the arrangement, including collateral contracts and legally unenforceable understandings between the parties. Therefore, it is possible that non-legal understandings outside of traditional legal contracts and agreements are required to be taken into account.

Further, the Exposure Draft contains the term 'related arrangement', which adds further complexity given the already broad ambit of the term 'arrangement'. It implies (but does not make clear) a degree of nexus is required for a subsequent arrangement to be considered 'related', which potentially casts the net even wider. Relevantly, the Explanatory Memorandum notes that it is not necessary that the payment and the acquisition of the right to exploit an intangible asset is provided for in the same contract. Paragraph 1.31 then provides an example whereby an Australian entity enters into a distribution agreement with an associate in a low tax jurisdiction, which makes no mention of any intangible assets, but access to valuable servers is provided to the Australian entity based on a 'common understanding', which constitutes a related arrangement for the purposes of the proposed measure.

Whilst the above relatively simple example is helpful in an illustrative sense, the already broad definition of 'arrangement' under the ITAA and the potentially unqualified scope of 'related arrangement' clearly has the potential to create uncertainty for taxpayers in identifying any relevant arrangement(s) covered by this measure.

To alleviate this and to reduce potential future disputes, further clarity is required (for example, by setting out what degree of nexus is expected) to effectively set the scope of inquiry into potential related arrangements. For example, Treasury may consider providing a non-exhaustive list of factors to consider (potentially in a form similar to the factors to have regard to for the purposes of Part IVA under subsection 177D(2) of the ITAA 1936) that should inform the investigation of related arrangements, including factors such as the degree of interdependence of arrangements, the form and substance of the arrangements, parties involved and existence of integrated and/or composite transactions.

Further, given the proposed measure applies to payments both made directly to an associate or indirectly through one or more entities, this adds further complexity and compliance difficulty in assessing related arrangements and may require a taxpayer to have regard to and full understanding of upstream contractual and non-legally enforceable arrangements between parties outside of Australia (and who potentially are not located in a low corporate tax jurisdiction), and potentially where those other entities are not even associates of the taxpayer. This point is addressed in further detail in the next section of this Submission.

Payments Involving Multiple Entities

As noted above, the proposed measure extends to payments made to a recipient directly or through one or more other entities, irrespective of the location of the immediate recipient (subsection 26-110(3)).

Therefore the Exposure Draft requires a 'look-through' approach to be adopted, notwithstanding the Explanatory Memorandum states that:

*Where income is derived indirectly, **strict tracing through the flow of funds is not required**, in particular, it is not necessary to demonstrate that each payment in a series of payments funds the next payment or is made one after the other. Rather, it is sufficient if the payment exists between each entity.*

[Emphasis added]

The words in the Explanatory Memorandum above are particularly similar to that used to determine indirect importations under Australia's imported hybrid mismatch rules under Subdivision 832-J of the ITAA 1997. In this regard, the approach taken to administer subsection 832-625(3) should be taken to be informative of potential challenges in adopting this 'look-through' approach, even if there is no strict tracing requirement.

Prior to the ATO's finalisation of its Practical Compliance Guideline PCG 2021/5² in relation to the imported mismatch rules, many of the industry's submissions centred around the challenges of complying with a 'tracing' exercise of the relevant payment, irrespective of the words in the legislation. This is because, in order to comply with the legislation (and PCG 2021/5) an Australian taxpayer is ultimately required and presumed (and expected) to have knowledge of overseas group structures, and the flow of funds through offshore groups, even if there may be no direct or commercial link to the payment in question. As highlighted in many of those submissions, this 'tracing' exercise in practice is operationally difficult and onerous to comply with.

In the context of the current proposed measure, any assessment of payments in existence between each offshore entity outside of Australia is likely to be equally difficult to undertake in practice for the same reasons as noted for the above integrity rule in subsection 832-625(3).

In particular, the Exposure Draft is drafted in a way such that irrespective of whether an immediate payment may be made by an Australian taxpayer to a jurisdiction that is not a low corporate tax jurisdiction, there is a requirement to look through beyond the immediate recipient, where the income is derived by an associate indirectly. This means that taxpayers will need to have an understanding of the upstream value chain outside of Australia, and tracing may be required even where the interposed entities are not associates or where there may be sufficient commercial substance to the arrangements between the associate and interposed entities outside of Australia.

In addition, given the proposed measure relies on the existing concept of 'associate' as defined under section 318 of the ITAA 1936, this may create additional challenges to obtain information as under Australian tax law, the concept of 'associate' extends beyond circumstances of controlled and commonly controlled entities, to entities that are relevantly 'sufficiently influenced' by another. Therefore, an Australian payer may be required to obtain information from and about an associate group, where there is otherwise no or limited common ownership between the relevant entities.

Meaning of 'Exploit'

The Exposure Draft under the proposed subsection 26-110(9) prescribes a broad definition of the meaning of "exploit" where to "exploit an intangible asset" includes amongst other uses, to "(e) *do anything else in respect of the intangible asset*".

It also includes simply having permission (in addition to a right), including implicit permission or an understanding between parties to exploit the intangible asset. Paragraph 1.52 of the Explanatory Memorandum states that:

² Imported hybrid mismatch rule - ATO's compliance approach.

*[t]his is commensurate with the provision being an anti-avoidance measure to capture a broad spectrum of arrangements to **minimise the risk of associates structuring arrangements in such a way as to circumvent the operation of the provision.***

[Emphasis added]

This passage implies that there needs to be a *deliberate intent* to structure one's affairs in order to circumvent the operation of the provision. As recommended earlier in this Submission, in our view, such a risk is more appropriately dealt with by introducing a 'purpose' test, rather than using a catch-all provision which is drafted so broadly so as to effectively include *anything* that is done in respect of an intangible asset.

It is also difficult to reconcile, absent a purpose test, how such a catch-all provision would not bring (unintentionally, in our view) all payments with respect to intangible assets to low corporate tax jurisdictions within the scope of the measure, which would go beyond the stated purpose set out in paragraph 1.47 of the Explanatory Memorandum that the proposed provisions are not intended to:

...inappropriately apply to genuine supply and distribution arrangements between associates, where there is no tax avoidance behaviour.

Further, we understand that Taxpayer Alert TA 2018/2³, which preceded the current proposed measures, included an exception such that the TA should not apply to "resellers of finished tangible goods where the activity or reselling the goods involves an incidental use of a brand name that appears on the goods and related packaging." This is another reason as to why in our view, the current drafting, in particular of paragraph 26-110(9)(e), is too broad.

Lastly, we note that certain other examples of activities contained in the Explanatory Memorandum (at paragraph 1.52) that are considered to be within the meaning of exploiting an intangible asset include:

- the deploying of or accessing the output of an algorithm, or
- a right or obligation to distribute or sell products on behalf of an associate in return for consideration from either the associate or third-party customers that involves marketing, selling or distributing the intangible asset even when that intangible asset, such as a software licence, is distributed directly from the offshore associate to the customer.

In our view, without further qualification or clarification, the above are such broad-based examples that there is a material risk that genuine / commercial arrangements may be inadvertently brought into scope notwithstanding the relevant algorithm may be mass produced and without much

³ Mischaracterisation of activities or payments in connection with intangible assets

proprietary value; or in the latter example, it is conceivable that common buy/sell or agency arrangements may be caught. We recommend that further clarification is provided in order to qualify the specific use cases that are intended to be included within the scope of the proposed measure.

Mischaracterisation and “apportionment”

One of the key aims of the proposed rules is to capture mischaracterised payments, as stated in the Explanatory Memorandum at paragraph 1.1:

These amendments apply where a contract provides that a payment is made for other things, such as services or tangible goods, and the arrangement also results in the SGE or another entity exploiting, or acquiring a right to exploit, an intangible asset, even at no cost.

It further goes on to state, at paragraph 1.38:

*In these cases, a deduction that is denied for a payment **attributable** to the right to exploit an intangible asset may be **apportioned**. Where such an acquisition results from the arrangement that provides for the payment (**regardless of whether it is stated in the written contract that the payment is for services or tangible goods**), a deduction for the payment will be denied to the extent that **the payment is attributable** to the right to exploit the intangible asset.*

[Emphasis added]

The Exposure Draft clearly contemplates a degree of apportionment to occur, regardless of what is stated in contemporaneous documentation between the parties.

We note that the ability to definitively calculate an attributable payment (or unbundle a payment) for the right to exploit an intangible asset within a broader payment for goods and services may be extremely challenging commercially and potentially impossibly complex in some circumstances.

The leading Australian authority on apportionment is *Ronpibon Tin NL v Federal Commissioner of Taxation*⁴ which was in relation to types of outgoings that required apportionment. It was held that, how an apportionment will be made will be a question of fact, with regard to the peculiarity of the matter.

There is currently no guidance or commentary in either the Exposure Draft or Explanatory Memorandum on how such an apportionment exercise should be undertaken for the purposes of the proposed measure. Furthermore, whilst Example 1.1 of the Explanatory Memorandum recognises

⁴ [1949] HCA 15, at [21].

the need to apportion a payment amount, it does not offer any suggestions as to how this apportionment might be performed.

We note a similar issue was raised in the ATO's draft ruling TR 2021/D4⁵ in relation royalties and character of receipts in respect of software, and it is still unclear how such an apportionment should be approached, which highlights the vexing nature of this issue.

Relevantly, there are a number of transfer pricing methodologies that could be used to apportion payments. Indeed, some of the existing transfer pricing methodologies may be more appropriate to address the pricing of royalties and their use, rather than seeking to design a prescriptive bright line test that requires taxpayers to determine the attributable value of intangible assets in a transaction.

In addition, we note that regard should be had to relevant OECD Commentary to Article 12 of the *Model Tax Convention On Income and Capital*. For example, in respect of payments for exclusive distribution rights, the OECD states⁶:

*Payments that are solely **made in consideration for obtaining the exclusive distribution rights** of a product or service in a given territory **do not constitute royalties as they are not made in consideration for the use of, or the right to use, an element of property included in the definition.** These **payments, which are best viewed as being made to increase sales receipts**, would rather fall under Article 7. An example of such a payment would be that of a distributor of clothes resident in one Contracting State who pays a certain sum of money to a manufacturer of branded shirts, who is a resident of the other Contracting State, as consideration for the exclusive right to sell in the first State the branded shirts manufactured abroad by that manufacturer. In that example, the resident distributor does not pay for the right to use the trade name or trade mark under which the shirts are sold; he merely obtains the exclusive right to sell in his State of residence shirts that he will buy from the manufacturer.*

[Emphasis added]

The OECD Commentary also provides guidance on and contemplates questions of apportionment. For example, in the case of a franchising arrangement, the OECD notes that where possible (and as far as can be broken down based on information contained in a 'mixed' contract), the consideration should be subject to a reasonable apportionment. However, and importantly, the OECD goes on to note⁷:

*If, however, **one part of what is being provided constitutes by far the principal purpose of the contract** and the other parts stipulated therein are only of an ancillary and largely unimportant*

⁵ Income tax: royalties - character of receipts in respect of software.

⁶ OECD Commentary on Article 12, at [10.1].

⁷ OECD Commentary on Article 12, at [11.6]

character, then ***the treatment applicable to the principal part should generally be applied to the whole amount of the consideration.***

[Emphasis added]

Given the noted and ongoing complexities as regards questions of apportionment on royalties and other intangible arrangements, further clarification is required (including detailed examples) on how any apportionment is expected to occur, including what factors should be taken into account. Further, we submit that the Exposure Draft should have regard and provide for an approach that is consistent with that put forward in the OECD Commentary, which should ensure that the tax treatment should align with globally accepted principles.

'Low Corporate Tax Jurisdiction' Test

Under the Exposure Draft, a low corporate tax jurisdiction is one where the lowest corporate income tax rate under the laws of that foreign country, applicable to an SGE, is less than 15% or nil. Relevantly, the Explanatory Memorandum states that only national level corporate tax is relevant for determining whether a foreign country is a low corporate tax jurisdiction.

As presently drafted, and for the reasons set out below, in our view the definition requires refinement as the scope of potential low corporate tax jurisdictions could be extremely (and unintentionally) broad.

Modifications to 'Headline' Corporate Income Tax Rate

As noted, the general rule for determining a low corporate tax jurisdiction is by taking the lowest corporate income tax rate applicable to an SGE in a particular foreign country. Prima facie, this indicates that the 'headline' tax rate applicable to corporates in that foreign country should be used (rather than say, the effective tax rate of a taxpayer which may take into account particular tax attributes of that taxpayer such as losses or credits).

However, this general rule is then subject to various 'modifications' set out under subsection 960-258(2). For example, the legislation specifically requires that the effect of deductions, offsets, tax credits, tax losses, tax treaties and concessions for intra-group dividends be disregarded (paragraph 960-258(2)(a)).

The presence of this subsection is confusing and unnecessary if the effective tax rate of a taxpayer in that country is effectively irrelevant. These individual attributes, that exist at a taxpayer level only, should have no bearing (and therefore be irrelevant) to the headline corporate tax rate of a jurisdiction. We recommend that this subsection be removed or otherwise further clarity is provided

in the drafting and Explanatory Memorandum to explain the relevance of these matters in applying the new measure.

Under paragraph 960-268(2)(b), the tax rate applicable to non-residents is disregarded (i.e., only the tax rate for resident taxpayers, assuming it differs, is considered). More clarification should be provided in the Explanatory Memorandum in relation to any taxpayers who currently derive relevant income at or through a permanent establishment (**PE**) in the low corporate tax jurisdiction, and the resident and non-resident tax rates differ. For example, assuming Company X (tax resident in Country A, a non-low corporate tax jurisdiction) operates in Country B (a low corporate tax jurisdiction with resident corporate tax rate of say 12.5%) through a PE and derives income attributable to an intangible asset (indirectly from an Australian taxpayer) and is subject to a non-resident tax rate of 15% in Country B. In applying the test under this paragraph, Company X may be unfairly disadvantaged if only the resident tax rate is taken into account, resulting in the arrangement being brought into scope such that the Australian taxpayer is denied a deduction irrespective of the actual tax rate applicable.

Next, under paragraph 960-258(2)(d), the tax rate is taken to be nil if no income tax is payable on a particular amount of income. Similar to above, to the extent a country's headline corporate tax rate is to be used, the presence of particular exemptions on certain types of income should arguably not be relevant to that determination. Further, the present drafting could be interpreted in a way that results in an anomalous outcome whereby the relevant corporate tax rate for a jurisdiction is taken to be nil for the purposes of this measure (on the basis that a jurisdiction offers certain exemptions from income tax), even if the taxpayer in question is not in fact relying on any such exemption(s) and/or the exemption(s) are not relevant to the income under scrutiny. Such an interpretation would also, in our view, unintentionally expand the in-scope jurisdictions given most countries (including Australia) commonly provide for exemptions from tax on certain items (e.g., participation exemption on qualifying dividends and capital gains, investment incentives and other concessions). We recommend this subsection is amended to limit its application to circumstances where the particular local exemption is in fact being applied to the arrangement in question.

Under paragraph 960-258(2)(e), where there are different rates of income tax for different types of income, the relevant tax rate is taken to be the lowest. For the same reason as above, we recommend this paragraph is amended to limit its application to circumstances where a particular tax rate is in fact being applied in respect of income derived from the arrangement in question (assuming there is no single headline corporate tax rate applicable). Otherwise, the drafting would also have the effect, in our view, of unintentionally expanding the in-scope jurisdictions to those with differing tax rates on different types of income, even if those rates may have no relevance to the arrangement in question.

Basis for exclusion of sub-national taxes

As noted, only national level corporate tax is relevant for determining whether a foreign country is a low corporate tax jurisdiction.

In our view, there is insufficient clarity and explanation as to the rationale for excluding sub-national taxes applicable to SGEs in foreign jurisdictions, such as state, province, canton or other similar regional and local taxes. This could be a critical consideration where jurisdictions have a national corporate tax rate that is lower than 15%, however, have an aggregate tax rate in excess of 15% when regional and local taxes are taken into account (for example, Switzerland).

In particular, the exclusion of sub-national taxes would appear to be inconsistent with the position under other parts of the ITAA. For example, under Taxation Ruling IT 2437⁸, the Commissioner considered and identified the types of foreign taxes eligible for credit against Australian income tax. Relevantly, whilst the tax law does not identify specific taxes of particular countries as being either creditable or not creditable, a key criteria for the availability of foreign income tax offsets is that the foreign tax must be imposed on a basis substantially equivalent to that on which the ITAA operates. Taking the example of Switzerland further, under IT 2437, Swiss Federal, cantonal and communal taxes on income are all specifically listed as creditable against Australian income tax (implying that those sub-national taxes are considered to be imposed on a basis substantially equivalent to the Australian tax law).

The Explanatory Memorandum does not provide any further clarity on the exclusion of sub-national taxes and in our view, there is no sound reason to adopt a position on foreign taxes here that should be inconsistent with other parts of the tax law, and in particular, we submit that certain sub-national taxes should be included in considering the relevant corporate income tax rate, where such sub-national taxes would be eligible for a foreign income tax offset against Australian income tax under a similar analysis set out in IT 2437.

Consideration of top-up taxes

The Exposure Draft does not taken into account other potential taxes that may operate outside of a country's corporate income tax. For example, where the particular payment is already subject to a rate of tax above 15% in another jurisdiction under a controlled foreign company (**CFC**) or similar regime.

Further, and importantly, the Exposure Draft and Explanatory Memorandum do not acknowledge the interactions with the impending Pillar Two rules, and it is unclear how the measure will work (and

⁸ Income tax : foreign tax credit system - foreign taxes eligible for credit against australian income tax.

how the 'low corporate tax jurisdiction' test will operate) in respect of any top-up taxes that may arise under either the Income Inclusion Rule (**IIR**) and/or a Qualifying Domestic Minimum Top-up Tax (**QDMTT**).

Unless further clarification is provided, there could be a potential risk of double taxation outcomes which would be undesirable and unintended. In our view, in applying the 'low corporate tax jurisdiction' test, the measure should take into account any other tax regimes that may result in top-up taxes in excess of 15% (rather than a sole focus on the headline corporate income tax), and whether arising in the particular foreign jurisdiction or in another foreign jurisdiction.

In order to reduce the uncertainty and complexity noted, we submit that one possible solution could operate in a similar manner to the integrity rule contained in the Hybrid Mismatch provisions (subsection 832-725(4)), which takes into account any part of a payment that has been taxed under relevant CFC rules (including foreign equivalent regimes), when determining whether a deduction should be denied.

Preferential Patent Box Regime

Under proposed paragraph 960-258(1)(b), a foreign country that is determined under subsection (3) is also a low corporate tax jurisdiction. The Minister has discretion (under subsection 960-258(3)) to determine a foreign jurisdiction to be a low corporate tax jurisdiction for the purposes of the propose measure, where the Minister is satisfied that the income tax laws of the foreign jurisdiction provide for a preferential patent box regime without sufficient economic substance.

Under subsection 960-258(4), in exercising that discretion, the Minister may have regard to any relevant findings, determinations, advice, reports or other publications of the Council of the OECD. However, we submit that regard should also be had as to whether the relevant income derived in that jurisdiction is subject to the concessional treatment of that preferential patent box regime. Given the broad scope of the proposed measure, it is possible that the types of income derived is not actually within scope of the relevant patent box regime, but a determination would have the effect that all royalties paid to that jurisdiction would be treated as being paid to a low corporate tax jurisdiction.

Risk of Double Taxation on Royalty Arrangements

The legislative intent behind the measure, as stated in the draft Explanatory Memorandum, is to deter SGEs from avoiding income tax, including withholding tax. In particular, one of the stated concerns (at paragraph 1.13) is around arrangements under which:

*...the mischaracterisation of the payment typically **results in royalty withholding tax not being paid....***

[Emphasis added]

However, it should be noted that the Exposure Draft (and Explanatory Memorandum) is silent on any interaction between this measure and withholding tax that may already be levied on a payment (notably 30% royalty withholding tax under Australia's domestic legislation, which may be reduced under applicable double tax treaties). In our view, the collection and payment of royalty withholding tax (whether at the domestic tax rate or reduced under relevant double tax treaties) should be a relevant factor in determining whether a payment attributable to intangibles has been adequately subject to tax in Australia.

In particular, the current drafting potentially gives rise to a risk of double taxation in Australia for the same arrangement (e.g., Australian withholding tax imposed on the non-resident recipient and the Australian payer being denied a deduction on the payment), which is incongruous with a key intent behind the rule as stated above, being to target payments which "result in no withholding tax being paid". If not nullified, this could result in a highly punitive and uneconomic outcome in situations where there may be no intent to avoid income tax, including withholding tax. This outcome would reduce the commercial competitiveness of these taxpayers, which would be an unintended consequence of the measure given the stated aim.

Importantly, on the one hand, should the Government's concern be around a question of mischaracterisation (which was addressed earlier in the Submission), we note that the Commissioner of Taxation already has the ability to challenge a taxpayer's position and issue amended assessments (to the extent the taxpayer has not discharged its burden of proof). In such instances there would be no shortfall of relevant withholding tax.

If, on the other, should the concern be one around ensuring the *quantum* of royalty withholding tax, then consideration should be given as to whether the proposed measure should only apply to deny a deduction if the payment is not already subject to a 'minimum' amount of royalty withholding tax. Otherwise, the risk of double taxation as noted above would apply to royalty payments to many non-treaty countries that are already subject to 30% royalty withholding tax (bringing the effective tax rate on such payments to 60%). Further, we note that should this be the concern, then it should be highlighted that this is inconsistent with the wording in the Explanatory Memorandum, which as noted above is clear that the measure is targeted at payments which "result in **no** withholding tax being paid" (rather than 'insufficient' withholding tax).

Further, if in fact this is the relevant concern (being the quantum of royalty withholding tax), then inherently the proposed measure would appear to negate and disregard a portion (or all) of the royalty withholding tax reduction that has been mutually and voluntarily agreed to by Australia and its relevant treaty partners, which from a policy perspective is an inappropriate outcome in our view. In addition, many of the treaty partners with Australia that provide a reduced royalty withholding

tax rate, are not the types of low corporate tax jurisdictions, or 'tax havens', that this measure is intended to capture, which is another inconsistency of the current drafting in our view.

Accordingly, we submit that, to the extent a payment is already subject to Australian withholding tax (or as an alternative, a 'minimum' amount of Australian withholding tax), the proposed measure should not apply to deny the payer a deduction. We consider that this approach would be aligned and consistent with the legislative intent and the measures originally announced by the Labor Party in 2019.

Shortfall Penalty Provision

The Explanatory Memorandum notes that a shortfall penalty provision is being considered as:

...a punitive measure to penalise SGEs who mischaracterise such payments in an attempt to avoid income tax, including withholding tax.

As the Explanatory Memorandum includes a reference to withholding tax, this appears to suggest that the proposed penalty provision can also apply to mischaracterising payments where part of the payment relates to a royalty.

It is unclear in the Explanatory Memorandum whether this shortfall penalty would only apply if there is a low tax jurisdiction connected with the payment or whether it would apply over and above the existing penalties for failure to withhold.

In this regard, in respect of royalties, we note that penalty provisions for ordinary withholding tax rules already exist. In particular, where an entity fails to withhold, they are liable to a penalty equal to the amount of withholding. Additionally, the entity is not entitled to deduct the amount as an income tax deduction pursuant to subsection 26-25(1) of the ITAA 1997.

In relation to arrangements other than royalty arrangements, in our view, the potential costs associated with a denial of relevant deductions at the Australian corporate tax rate already acts as an appropriate measure to deter any such mischaracterisation, without the need for a specific shortfall penalty provision.

Further, as noted earlier in this Submission, the proposed measure adopts a results-based approach, instead of including a purposive requirement. In our view, absent a purpose test, which would evidence any clear intent to structure for the purposes of avoiding income tax, we submit the proposed shortfall penalty provision is unnecessary and should not be introduced.

Lack of examples provided in the Explanatory Memorandum

The Explanatory Memorandum states that:

As an anti-avoidance rule, these amendments are intended to have a broad application.

Indeed, to reflect this, at numerous instances throughout the Explanatory Memorandum, key definitions and terms (such as 'exploit' and 'intangible assets') are noted to take on a *broad* meaning. Accordingly, given the breadth of the proposed measure, it could potentially apply to a wide range of industries and arrangements.

Despite a broad scope of application, we note that the Explanatory Memorandum only includes one example, being Example 1.1 (at paragraph 1.32) dealing with a relatively straightforward case of importing, marketing, and selling tangible goods (clothing and shoes). In this example, the Australian entity pays for management and other services it acquires under the agreement; and it is allowed (at no cost) to display logos etc when marketing the goods. The example concludes, without explanation, that a portion of the management fee paid to the other party is attributable to exploiting intangible assets (being both the trademark and sub-license). To that extent, it was concluded that payments made by the Australian entity are non-deductible.

Importantly, the commentary on Example 1.1 does not provide any further guidance on the rationale for the conclusion or how to quantify the non-deductible portion of the payment. It simply states that, "*to the extent that the payment of these fees is attributable to the right to exploit the trademark ...*" it will be non-deductible.

As noted earlier in this Submission, it is not entirely clear how the conclusion under Example 1.1 (that Australian entity is considered to exploit the intangible assets) reconciles with paragraph 1.47 of the Explanatory Memorandum which states that "*trademarks printed on finished goods that are marketed and sold by an SGE to customers, without payments to an associate being mischaracterised or being effectively for the use of that trademark in the SGE's business beyond the mere marketing and selling of those finished goods, would be unlikely to attract the operation of this anti-avoidance rule.*"

In order to give taxpayers and advisors additional certainty on the scope of the proposed measure, we recommend that the Explanatory Memorandum should include additional examples (preferably dealing with different types of intangible assets, across industry sectors, jurisdictions, and direct/indirect payment flows) as well as provide more detailed guidance on the analysis of the existing example against the stated intent of the proposed measure.

Non-discrimination Articles Under Double Tax Agreements (DTAs)

Certain of Australia's DTAs contain a non-discrimination article, in line with Article 24(4) of the *OECD Model Tax Convention*, which states:

interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.

The DTA with Switzerland, for example, contains such a non-discrimination article⁹ and as noted earlier in this Submission, Switzerland has a headline corporate tax rate of less than 15%. Accordingly, it should be clarified how the proposed measure is intended to interact with the relevant Australian DTAs which contain an equivalent non-discrimination article.

Further, given the proposed measure may operate to deny a deduction in Australia where the income is either directly or indirectly derived in a low corporate tax jurisdiction, consideration and guidance should also be provided as to situations where either the immediate recipient jurisdiction has a DTA with Australia containing a non-discrimination article (but the ultimate recipient jurisdiction does not); or alternatively where where the ultimate recipient jurisdiction has a DTA with Australia containing a non-discrimination article (but the immediate recipient jurisdiction does not).

Commencement Date

The proposed new law will apply to payments made or credited, or liabilities incurred on or after 1 July 2023.

For a number of reasons (which have been covered in this Submission) primarily relating to the broad legislative drafting, the threshold for being brought within the operation of the proposed measure can be quite low, especially if the legislation is adopted in its current form. This means that the potential in-scope taxpayers and arrangements may be wider than anticipated based on the initial and previous announcements of this measure.

Given the short lead time to conduct consultation before the rules potentially commence, there is very little time for taxpayers to prepare and consider appropriate actions across their global structures and value chain. Such actions may include a review of all relevant intangible arrangements involving a payment offshore and whether any payment ultimately is derived in a low corporate tax jurisdiction (including the scope of any 'related arrangements'), conducting enquiries as to any further upstream payments for intangibles, an assessment and analysis of any apportionment of current payments (and if so, a determination of the appropriate basis for apportionment), and in certain cases, a consideration of the appropriateness of migration of the relevant intangible assets.

⁹ Article 23(3), Convention between Australia and the Swiss Confederation For the Avoidance of Double Taxation With Respect To Taxes on Income.

The majority of those decisions require senior stakeholder approval and any restructure of global arrangements (assuming appropriately supported by commercial rationale) are likely to require some time for due diligence, assessment of alternatives and implementation. This means that for impacted taxpayers, the lack of time to undertake these workstreams will mean they are exposed to the cost of denial of deductibility.

Accordingly, we submit that the commencement date of the proposed measure should be deferred for a period of 12 months, to allow for full consultation on the drafting issues noted and the provision of relevant guidance and examples. This will allow taxpayers to assess any potential impacts on their business operations and provide sufficient time to consider any require actions.

If you have any queries on any of our comments above, please contact Vanja Podinic on 02 9258 5932.

Yours faithfully,

Ashurst

The logo for Ashurst, featuring the word "ashurst" in a lowercase, bold, sans-serif typeface.