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Ronita Ram
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By Email: MNETaxIntegrity@treasury.gov.au

Dear Ms Ram

**MULTINATIONAL TAX INTEGRITY – DENYING DEDUCTIONS FOR PAYMENTS
RELATING TO INTANGIBLE ASSETS CONNECTED WITH LOW CORPORATE TAX
JURISDICTIONS**

1. Thank you for the opportunity to provide comments to Treasury in relation to the exposure draft legislation (“**ED**”) and explanatory memorandum (“**EM**”) relating to the proposed measure to deny significant global entities (“**SGEs**”) deductions for certain payments relating to intangible assets.
2. Pitcher Partners specialises in advising taxpayers in what is commonly referred to as the middle market. Accordingly, we service clients that may be disproportionately affected by the cost of compliance with measures that ostensibly target multinational tax avoidance practices.
3. We understand Treasury’s intends for the proposed measure to be consistent with attracting investment and genuine commercial activities in Australia without imposing excessive compliance costs for business. In this regard, we highlight that businesses incur significant costs and risks to produce intangible assets and should be entitled to a fair reward on such an investment. Adopting an overly broad role to deny deductions for all payments related to the exploitation intangible assets connected with low corporate tax jurisdictions is likely to disincentivise foreign investments and developments being entered into and/or rolled out into Australia. As a result. Australia may miss out, or be delayed access to, the benefits of ground-breaking developments if Australia is viewed as a commercially problematic or overly burdensome jurisdiction in which to operate.
4. Australia has existing laws and guidance in place to address the tax implications of shifting assets, risks and functions in respect of intangibles. These are significantly

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complex. Rather than introducing additional laws that further increase the existing level of complexity, the current rules should be enforced.

5. We believe that this legislation is being rushed without giving consideration to Pillar 1 and Pillar 2 under the Base Erosion and Profit Shifting (“**BEPS**”) Framework.
6. Lastly, we highlight that there are a number of technical and practical deficiencies contained in the current design of the ED. We believe that many of these are critical and need to be addressed before legislation is introduced. As such, the commencement date of 1 July 2023, should be delayed.
7. We have reviewed the draft ED and EM and following feedback from our internal technical team and our clients, we have provided below our commentary and recommendations as to how the proposed measures can be adjusted with the aim of ensuring this measure properly targets its intended purpose. Specifically, our comments address the following areas:
 - 7.1. Scope of low corporate tax jurisdictions;
 - 7.2. Lack of a tax purpose test;
 - 7.3. Interaction with Australian royalty withholding tax;
 - 7.4. Uncertainty relating to apportionment and bifurcation;
 - 7.5. Breadth of meaning of intangible asset, arrangement and associate;
 - 7.6. Start date and *de minimis*; and
 - 7.7. Proposed penalties.

Measure should be appropriately targeted

8. As currently drafted, the measure contains a number of uncertainties not least the scope of “low corporate tax jurisdictions”. The determination of a low tax jurisdiction is expansive; involving complex determinations of the corporate income tax rate across multiple jurisdictions whereby one must disregard deductions, offsets, tax credits, tax losses, tax treaties and concessions for intra-group dividends and rates that apply to foreign residents (amongst other things), bringing additional jurisdictions into scope that are not customarily considered to be low tax jurisdictions.
9. In order to simplify the operation of the proposed measure more broadly, we believe that it could be modelled on certain features contained in the hybrid mismatch rules which contain an integrity measure that disallows deductions for payments of interest to low tax or no tax interposed foreign lenders.
10. In particular the “Low Corporate Tax Jurisdiction” concept should be replaced with a “not subject to Australian income tax” and “subject to foreign income tax¹ at less than 15%” tests. This would focus on the rate at which tax is paid on the specific payment being considered, regardless of the headline corporate tax rate in the country in which the income is derived. For example, if the specific payment is taxed at greater than

¹ As defined in section 832-130 ITAA 1997.

15%, it should not be relevant that other income or profits are taxed in that country at less than 15%.

11. These “subject to income tax tests” consider whether the amount is ultimately subject to income tax in another country other than the one in which the income is derived by considering whether the controlled foreign company rules² of a country (including Australia) operate to tax the payment in a higher tax jurisdiction. Such an approach may ultimately also factor in any “Top-up tax” that is paid in accordance with the forthcoming Pillar Two measures.

Purpose test

12. The measure is intended to be an anti-avoidance rule and therefore should include a principal purpose test³ so that it does not capture arrangements which are not tax driven. For example, this would allow the substance of any arrangement to be considered so that arrangements are not impugned where they involve intangible assets genuinely developed by businesses with employees located in low-tax developing countries. As currently drafted, the measure places Australia at a competitive disadvantage by adopting such a unilateral measure that does not have regard to the substance of any arrangement. Consequently, groups may look to minimise their exposure to Australia if genuine commercial arrangements will bear an excessive tax burden.

Withholding tax

13. Additionally, the effect of Australian withholding taxes should be considered. In particular, any payments relating to intangible assets that are royalties subject to Australian withholding tax should not be subject to denial. Many royalty payments to low tax jurisdictions are not covered by any tax treaty and taxed in Australia at source at 30%. Clearly if such payments do not give rise to tax integrity concerns and it would be unfair to effectively tax these payments again by denying deductions as well as imposing a 30% withholding tax on the non-resident recipient. Therefore, a “subject to Australian income tax” test could be adopted that modifies the meaning of that term (as currently defined) by including amounts subject to tax payable in accordance with subsection 128B(5A) of the *Income Tax Assessment Act 1936* (“**ITAA 1936**”).

Apportionment and bifurcation

14. We refer to paragraph 1.20 of the EM which provides that a deduction will be denied “to the extent that the payment is attributable to a right to exploit an intangible asset.” This text in the EM contemplates some degree of apportionment to occur, regardless of what is stated in the legal agreement between the relevant associated entities. The taxpayers would need to review its arrangements and determine an appropriate method or approach to attribute value to the right to exploit the intangible assets.
15. How such an exercise is undertaken is entirely unclear leaving taxpayers in a position of great uncertainty as they would have little comfort that their view would be consistent with the ATO’s.

² For example, refer to subsections 832-125(3) and 832-130(5) ITAA 1997.

³ See paragraph 832-725(1)(h) ITAA 1997.

Breadth of the ordinary meaning of intangible asset

16. The term “intangible asset” is undefined in the ED and therefore takes an extremely broad meaning due to the lack of any statutory limitation (other than potential regulations). While paragraph 1.47 of EM provides that the rule is not intended to apply to genuine supply and distribution arrangements, this exclusion seems only relevant where an Australian entity pays for a tangible asset (e.g. goods). However, where a genuine supply arrangement is for a service, the exclusion in proposed subsection 26-110(7) would generally not apply. Therefore, payments for ordinary services which involve any form of licence would be within scope (e.g. for the simple use of software which would not be considered a royalty). We therefore believe that exclusions should also cover intangible assets that are merely incidental to the supply of services. We suggest that the payments within scope could use an existing definition that is well understood (e.g. royalties).

Breadth of the meaning of arrangements and related arrangements

17. An “arrangement” is broadly defined in the ITAA 1997 (e.g. including non-enforceable undertakings). This will cause additional complexities involving taxpayers to look outside legal agreements with the further expectation around tracing of payments through their global value chain which would be both costly and complex to administer. Additionally, the concept of “related arrangement” is novel and it is difficult for taxpayers to understand when one arrangement would be considered to be “related” to another arrangement but nevertheless two separate arrangements.

Associate

18. The ED refers to “associates” in numerous instances. This term has a broad definition in section 318 ITAA 1936 and can extend beyond circumstances where entities have influence over one another’s decision-making. As a result, a payer maybe required to obtain information from and about an associate group, where there is otherwise no or limited common ownership between the relevant entities.

Economic distortion side effect

19. The ED only applies to intangible asset arrangements with low taxed associates whilst arrangements with low taxed third parties remain fully deductible. Without exemption for genuine business, the ED may create unintended economic distortion for multinational enterprises with Australian subsidiaries with respect to the choice to vertically integrate a supply chain. This distortion is created by the fact that the choice between paying for the use of an intellectual asset from a third party organised in a low tax country as compared to developing it internally in a low tax country carrying an additional 30% tax burden.

De minimis

20. We also believe a *de minimis* rule, similar to that applicable to the thin capitalisation rule would be appropriate. While the measure only applies to SGEs, we highlight that many inbound SGEs do not undertake substantial activities in Australia such that the scope for tax avoidance through complex arrangements involving intangibles is low, while the cost of considering the application of this proposed measure would be high. As such, a *de minimis* rule should be adopted whereby entities part of local groups that have less than \$2 million of payments attributable to rights to exploit intangible assets are not subject to the provision.

21. Many SGEs have a small or medium sized footprint in Australia. As such, having regard to comments above, the compliance cost of undertaken extensive inquiries about offshore arrangements and conducting the contemplated apportion and bifurcation exercise may outweigh the actual transactional value in many cases. The cost of properly administering the measure is also likely to be extensive with smaller transactions likely to be extensive. Hence, we reiterate that a *de minimis* rule would be appropriate for this measure.

Administrative penalties

22. Lastly, we refer to paragraph 1.40 of the EM which considers whether an additional shortfall penalty should be introduced for this measure specifically. We highlight that SGEs are already subject to double the shortfall penalties as compared to other taxpayers (i.e. up to 180% of the tax shortfall for repeated intentional disregard). We do not see a reason to introduce an additional penalty seeking to penalise SGEs further for this measure in particular. Instead, any penalty should be determined in accordance with current practices (e.g. by considering whether the taxpayer was careless, reckless or otherwise intentionally disregarded the law).

Lack of examples in the EM

23. The EM contains only one detailed example regarding the application of the proposed measure. To help taxpayers understand the likelihood of the measure applying, the EM should have additional examples to assist taxpayers further.

Delay the start date

24. We understand from the EM that it is proposed that this measure in Australia apply for income years beginning on or after 1 July 2023. Given the ED and EM were only issued on 4 April 2023, this timeframe from provides insufficient time to educate and prepare for the introduction of this new measure which is unlikely to receive Royal Assent prior to its operation. We strongly recommend that the start date of the new rules is deferred by 12 months to income years commencing on after 1 July 2024. This would allow taxpayers a fair chance to consider these complex rules and their impacts on existing arrangements after considering any guidance that the ATO will need time to develop before the rules become operative.

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If you would like to discuss any aspect of this submission, please contact either Leo Gouzenfiter on (03) 8612 9674 or me on (03) 8612 9209.

Yours sincerely



A O'CARROLL
Executive Director