

1 May 2023

Ronita Ram
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Tax Treaties Branch
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: MNETaxIntegrity@treasury.gov.au

Dear Ms Ram,

Denying deductions for payments relating to intangible assets connected with low corporate tax jurisdictions

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the Treasury Laws Amendment (Measures for Consultation) Bill 2023: Deductions for payments relating to intangible assets connected with low corporate tax jurisdictions exposure draft bill (**draft Bill**) and the accompanying explanatory memorandum (**draft EM**).

We thank the Treasury for meeting with us to discuss our concerns and feedback with respect to the draft Bill and draft EM. We appreciate Treasury's openness to discussing the proposed measure and the opportunity to partake in the development of its design to ensure it achieves its policy intent in an equitable manner.

In the development of this submission, we have closely consulted with our National Large Business & International Technical Committee to prepare a considered response that represents the views of the broader membership of The Tax Institute.

The draft Bill proposes to introduce an anti-avoidance provision targeted at denying deductions for payments relating to the exploitation of intangible assets to associates of significant global entities (**SGEs**) in low corporate tax jurisdictions. The draft Bill contains several definitions and concepts that are new to Australia's taxation system and which require greater clarity and guidance for taxpayers and tax practitioners.



The breadth of the proposed definitions for 'exploit' and 'intangible asset' are likely to result in a broader range of transactions than intended under the policy being caught within scope, resulting in potentially inequitable outcomes. We consider that these definitions should be refined and clarified to ensure they only apply when appropriate.

Similarly, the proposed definition for a 'low corporate tax jurisdiction' contains significant complexity and, as currently drafted, can capture higher tax jurisdictions which do not appear to be contemplated by the original policy. Subject to the next comment, we are of the view that the definition would benefit from tightening and refinement, with supporting guidance to better emphasise that it is intended to capture a country's headline corporate tax rate or alternatively, a specific preferential patent box regime. The proposed definition for a 'low corporate tax jurisdiction' should also take into account certain state taxes that exist in some countries. This would enable a fairer comparison as, in effect, a higher rate of corporate tax is collected across various levels of Government in certain jurisdictions.

Importantly, The Tax Institute is of the view that the proposed measure should include a dominant purpose test, ensuring it is better aligned with other anti-avoidance provisions and does not produce inappropriate outcomes such as penalising taxpayers undertaking transactions where there is no tax mischief. Further, we consider that additional shortfall penalties would be excessive and are not necessary, given the extensive penalty regimes to which SGEs are currently subject.

Finally, we consider that the start date for the measure should be delayed until 1 July 2024. This will ensure that taxpayers and tax practitioners have sufficient time to understand the implications of the changes on their circumstances. It will also allow time for the Australian Taxation Office (**ATO**) to provide the guidance needed to allow taxpayers to practically comply with their new obligations.

Our detailed response which is contained in **Appendix A**.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all.

If you would like to discuss any of the above, please contact The Tax Institute's Senior Tax Counsel, Julie Abdalla, on (02) 8223 0058.

Yours faithfully,



Scott Treatt

General Manager,
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Jerome Tse

Council Member

APPENDIX A

We have set out below our detailed comments and observations for your consideration.

Denial of deductions

Section 26-110 of the Bill broadly proposes to deny deductions for payments by SGEs to associates in low corporate tax jurisdictions that relate to the exploitation of intangible assets (as set out in the other provisions of the Bill). However, we consider that the deduction should not be denied in all of the circumstances outlined in the draft provisions.

For example, if the relevant payments are subject to royalty withholding tax, then we consider it to be an unfair outcome for the deduction relating to the payment to also be denied. This approach does not provide the SGE with an opportunity to recognise the cost of their expense relating to the intangible asset despite the transaction being low risk, as tax has been accounted for and paid by withholding. A similar inequitable outcome arises in instances where tax on amounts paid by SGEs to their associates is attributed under the controlled foreign company (**CFC**) regime.

Amounts derived indirectly

The effect of subsection 26-110(3) of the draft Bill is that it does not matter whether the payment is made directly or through one or more different entities, the deduction will be denied if the recipient derives income in a low tax jurisdiction. In our view, the current drafting may result in anomalous outcomes in light of the policy.

We acknowledge that an objective of the indirect requirement is to prevent the circumvention of the proposed measure. However, it may have the effect of denying deductions for a legitimate transaction. This is especially the case where there is no sole or dominant purpose test in place. Not all arrangements of this type are undertaken to achieve a tax outcome. In this instance, it is possible for all the parties to be dealing in a commercial manner (such as a sub-licencing arrangement at arm's length terms).

The deduction may be denied if the payment went from the Australian company to a low tax overseas jurisdiction and then to a high tax overseas jurisdiction. From a policy perspective, this is an anomalous outcome as the ultimate recipient of the payment is in a high tax jurisdiction, and again, there is no apparent tax mischief.

These instances may also be difficult to practically identify as a result of the application of the associate rules in section 318 of the *Income Tax Assessment Act 1936 (ITAA 1936)* to large and publicly traded companies. A SGE may not have visibility over the actions of, or information relating to, their 'associate' as they may be functionally independent, located in different jurisdictions, and do not have common management or leadership.

The Tax Institute is of the view that further consideration should be given to the current drafting of this rule and supporting guidance provided in the draft EM to ensure that it does not unfairly deny deductions. We note that if the indirect rule was removed, the general anti-avoidance provisions under Part IVA of the ITAA 1936 could still apply to transactions which seek to circumvent the proposed measure. Alternatively, a requirement that the transaction be entered into for the sole or dominant purpose of achieving the tax outcome could ensure that deductions are only denied in appropriate circumstances.

Tracing and apportionment requirements

An inherent feature of the draft Bill is the proposed requirement for impacted taxpayers to trace and apportion payments, potentially through numerous entities, in relation to the exploitation of intangible assets. Feedback from our members indicates that the broad definitions of ‘exploit’ and ‘intangible asset’ can result in thousands, or more, transactions needing to be identified, traced and apportioned. In some cases, the exploitation of intangible assets may be for immaterial value.

The compliance costs for taxpayers to undertake these steps is likely to far outweigh the revenue expected to be raised. We consider it important to ensure that the definitions in the draft Bill and supporting guidance in the draft EM appropriately narrow the scope of the provisions so they apply in a more targeted manner to arrangements of concern.

Intangible assets

Ordinary meaning

The definition of an ‘intangible asset’ will generally take on its ordinary meaning.¹ The draft Bill also introduces concepts that are proposed to apply in addition to the ordinary meaning of the term. Broadly, the measure is proposed to apply to intangible assets in the same manner that paragraphs (a), (c) and (e) of the definition of ‘royalty’ contained in subsection 6(1) of the ITAA 1936 apply to the use or supply of certain assets.²

We consider that this approach is likely to result in ambiguity given the numerous existing concepts of intangible assets contained in the Australian taxation and financial systems. For example, under the Australian Accounting Standards, an intangible asset is defined as:³

‘...an identifiable non-monetary asset without physical substance.’

However, this definition must be read having regard to the meaning of the term ‘asset’ and also to whether the intangible asset satisfies the relevant ‘recognition criteria’. Broadly, an asset is defined as a resource that is controlled by an entity as a result of past events and from which future benefits arise.⁴ Meanwhile, the recognition criteria requires that it be probable that the expected future economic benefits that are attributable to the asset will flow to the entity and that the cost of the asset can be reliably measured.⁵ This results in internally generated intangible assets⁶ and internally generated goodwill⁷ not being recognised as ‘intangible assets’.

¹ Subsection 26-110(8) of the Bill.

² Paragraph 26-110(5)(a) of the Bill.

³ Australian Accounting Standards Board (**AASB**) 138 *Intangible Assets (AASB 138)*, paragraph 8.

⁴ *Ibid*, paragraph 8.

⁵ *Ibid*, paragraph 21.

⁶ *Ibid*, paragraph 51–64.

⁷ *Ibid*, paragraph 48–50.

Under the International Valuation Standards (**IVS**), an intangible asset is defined as:⁸

‘...a non-monetary asset that manifests itself by its economic properties. It does not have physical substance but grants rights and/or economic benefits to its owner.’

Broadly, the IVS definition recognises that there are many types of intangible assets, but that they are often considered to fall into one or more categories (such as marketing, customer, artistic, contract or technology) or goodwill.⁹

The definition used by the IVS is regularly referred to in Australian courts.¹⁰ However, the IVS definition does not distinguish between intangible assets that do not fall into the category of goodwill and those that do. Further, certain intangible assets recognised in ‘IVS 210 Intangible Assets’ such as trade names, unpatented technology and non-contractual customer relationships would fall into the category of goodwill under Australian law.

The Macquarie Dictionary defines ‘intangible asset’ as:¹¹

‘an asset, such as a patent, copyright, brand name, etc., which has no physical properties but which can be identified, given a monetary value, and therefore recorded on a balance sheet.’

This definition is arguably based on the general accounting approach. However, the need for the intangible asset to be recorded on a balance sheet is usually an unnecessary requirement outside of an accounting context.

As demonstrated by these definitions, there is no consistent approach or meaning. Each of the definitions above takes specific meaning from the context in which it is used. Feedback from our members indicates that the proposed approach is likely to result in difficulties for taxpayers in determining whether their transactions fall within the scope of the measure.

To provide certainty, we consider that the draft Bill should include a statutory definition of the types of intangible assets intended to be covered by this measure. The draft EM would also benefit from more detailed guidance on the ‘ordinary meaning’ of an intangible asset. If the list of intangible assets intended to be covered by the measure is limited to those noted in paragraph 1.44 of the draft EM, this should be made clearer in the legislation.

Mining, quarrying and prospecting rights

Subsection 26-110(7) of the draft Bill aims to ensure that tangible assets are excluded from the scope of the measure. While a mining, quarrying, or prospecting right is likely to fall within the exclusion, we consider that the provision would benefit from certainty by specifically excluding these types of rights similar to the current exclusion in section 855-20 of the *Income Tax Assessment Act 1997 (ITAA 1997)*.

⁸ IVS 210, paragraph 20.1.

⁹ Ibid, paragraph 20.3.

¹⁰ For example, see *SPI PowerNet Pty Ltd v Commissioner of Taxation* [2014] FCA 261 at [27]; *Fonterra Brands (Australia) Pty Ltd v Bega Cheese Ltd* [2021] VSC 75 at [463].

¹¹ *Macquarie Dictionary* (7ed, 2017).

Definition of exploit

The measure introduces the novel definition of 'exploit', which covers a broad spectrum of arrangements beyond merely using an asset. Examples include selling, licensing, marketing, distributing, or supplying the asset. Paragraph 26-110(9)(e) of the draft Bill goes on to say that exploiting the intangible asset can include doing 'anything else' in relation to that asset.

Despite the definition being new to the tax system, there is limited guidance provided regarding how it is intended to apply. The broad nature of the definitions of 'exploit' and 'intangible asset' will likely result in unintended outcomes. This concern is exacerbated by the wide scope of paragraph 26-110(9)(e) and compounded given the inclusion in subparagraph 26-110(2)(c)(iv) of the words 'or from a related intangible asset'. For example, an Australian based employee accessing the procedures and manuals of an overseas associate for a minor aspect, such as leveraging a new team reporting protocol or confirming if the licensing rights for a piece of software are available, can trigger application of the measure. In these instances, there is likely to be an internal general cost sharing agreement that provides a value for these types of transactions in the aggregate. It would be practically unfeasible for SGEs to determine and apportion the appropriate amount for the 'exploitation' of the 'intangible asset' in such circumstances.

Currently, the draft EM only contains a brief description and one example where the outcome is otherwise evident from the definition. The Tax Institute is of the view that the current definition of exploit in the draft Bill should be more specific and narrowed to cover likely uses of an intangible asset. The definition should also be accompanied by more examples in the draft EM which highlight the nuances of an 'exploitation', including:

- the derivation of income from the direct exploitation of an intangible asset in a low corporate tax jurisdiction,
- the derivation of income from the indirect exploitation of an intangible asset in a low corporate tax jurisdiction;
- the derivation of income from the direct exploitation of a related intangible asset in a low corporate tax jurisdiction;
- the derivation of income from the indirect exploitation of a related intangible asset in a low corporate tax jurisdiction; and
- instances where intangibles are not exploited.

Low corporate tax jurisdiction

Scope of definition

Section 960-258 of the draft Bill proposes to introduce a new definition for a 'low corporate tax jurisdiction'. We understand that the provision is intended to refer to the headline corporate tax rate of an overseas jurisdiction. However, the current drafting results in a broader view being adopted. In particular, paragraphs 960-258(2)(d) and (e) of the draft Bill which states that:

- (d) '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; and
- (e) there are different rates of income tax for different types of income—have regard only to the lowest rate.'

These paragraphs can result in countries being classified as low tax jurisdictions if a 'type of income' receives concessional or nil treatment, even if that 'type of income' is not related to payments for the exploitation of intangible assets. Proposed subsection 960-258(2)(a) of the draft Bill will not sufficiently exclude all 'types of income' as it is limited in scope to only intra-group dividends. For example, capital gains that are not taxed in a jurisdiction (such as in New Zealand) may fall under the definition of a low corporate tax jurisdiction. This is because a capital gain may be a 'type of income' that is not subject to tax, thereby being deemed to have a nil rate of tax. However, this does not mean that those jurisdictions would be considered a 'low corporate tax jurisdiction' in the general sense. Further, from a policy perspective it is unclear why the tax rate for certain types of income unrelated to the payments for intangible assets would be a relevant consideration.

Further, it is uncertain how the proposed definition of a low tax jurisdiction treats the following concessional treatments;

- countries providing nil or lower tax rates for entities engaging in charitable or not-for-profit endeavours; and
- countries, or states within countries, that allow for a 'check-the-box' or equivalent flow-through treatment for a company (for example, the United States).

The draft Bill also does not acknowledge any taxes that might be paid as a result of a jurisdiction's application of the Pillar Two framework and, in particular, the application of the Qualifying Domestic Minimum Top-up Tax that might be imposed. With many jurisdictions advancing their implementation of the Pillar Two framework in coming years, this is a significant global feature that warrants consideration in the determination of whether a foreign country falls within the definition of a low corporate tax jurisdiction. Australia should not take an approach that leads to outcomes that are out of step with the global community in this regard.

Additionally, taxes that might be paid under CFC rules in another jurisdiction by an associated entity should also be taken into account in determining whether the intangible income is derived in a low corporate tax jurisdiction.

We consider it unreasonable for a country to fall into the scope of the low tax jurisdiction for the purposes of this measure solely due to one of these features being present in a country's tax regime. In either situation, there are justifiable policy reasons for the discount or the tax being subject to a higher rate at a different point in the country's taxation system.

As a result, The Tax Institute is of the view that paragraph 960-258(2)(e) of the draft Bill should be removed or significantly narrowed in scope to ensure that the definition only captures the headline tax rate of the country. This should be supported with guidance in the draft EM which illustrates this limitation.

Corporate taxes taken into consideration

Paragraph 1.55 of the draft EM states that only national level corporate taxes are taken into consideration when determining whether a country is a low corporate tax jurisdiction. We consider that certain state taxes, for example, State-based corporate income taxes in the United States and Cantonal-based corporate income taxes in Switzerland, should be taken into account. This will enable a fairer comparison as, in effect, a higher rate of corporate tax is collected across various levels of Government.

Preferential patent box regime

Subsections 960-258(3) and (4) of the draft Bill propose to grant the Minister power to determine by legislative instrument a low corporate tax jurisdiction if the relevant jurisdiction has a preferential patent box regime that is without sufficient economic substance. We consider that the term 'sufficient economic substance' should be defined in the legislation with examples provided in the draft EM to illustrate its intended operation. On its own, and as a matter of good governance, the term does not provide a sufficient criterion to determine whether the Minister's declaration is suitable for the relevant jurisdiction.

Further, subsection 960-258(4) of the draft Bill states that the Minister 'may have regard to any relevant findings, determinations, advice, reports or other publications of the Council of the Organisation for Economic Cooperation and Development (**OECD**)' when making the determination. However, the subsection does not require the Minister to consider, or be consistent with, the views of the OECD. This approach allows for discrepancies between Australia's approach and international standards, which can increase compliance cost and complexity for Australian taxpayers.

Sole or dominant purpose

The Tax Institute is of the view that the draft Bill should include a sole or dominant purpose requirement. This will ensure that the measure is consistent with other anti-avoidance provisions in the taxation legislation and reduce opportunities for unfair outcomes that can result from the application of the proposed broad concepts.

Consideration of shortfall penalty

Paragraph 1.40 of the draft EM states that Government is currently giving consideration to introducing a shortfall penalty as a punitive measure to penalise SGEs who mischaracterise payments in an attempt to avoid income tax, including withholding tax. SGEs have seen significant increases in potential penalties in recent times, including:

- doubling of the administrative penalty for false or misleading statements under Subdivision 284-B of Schedule 1 of the *Taxation Administration Act 1953* (**TAA 1953**); and
- doubling the penalty related to schemes where SGEs do not have a reasonable arguable position under Subdivision 284-C of Schedule 1 of the TAA 1953.

The current penalties regime for SGEs is more onerous and targeted than for other categories of taxpayers. We do not consider that there is a need for a further punitive tax penalty in instances where the proposed measure applies. The Tax Institute considers that introducing a shortfall penalty in this regard would be excessive in light of the abovementioned penalty regimes as well as potential implications resulting from further action under Part IVA of the ITAA 1936.

Clarification in the draft explanatory memorandum

The draft Bill proposes to introduce several new concepts and definitions into Australia's taxation system. Despite this, we consider that the draft EM does not provide sufficient detail to allow taxpayers to better understand these concepts and their impact on them. In addition to the recommended guidance outlined in our submission above, we consider that the draft EM would benefit from further clarification and examples concerning:

- the types of intangible assets being a right in respect of, or an interest in, a tangible asset referred to in paragraphs 1.46 and 1.47 of the draft EM to which the proposed measure is not intended to apply;
- what a 'finished good' is for the purposes of paragraph 1.47 of the draft EM;
- what a 'genuine supply and distribution agreement' is, as stated in paragraph 1.47 of the draft EM;
- a clearer outline of the tax avoidance behaviour the proposed measure is seeking to address, and why the updated transfer pricing rules in Subdivision 815-B of the ITAA 1997 do not adequately address such behaviour; and
- further guidance on how things such as 'know-how', 'trade secrets', and 'confidential information' would fall within the scope of the proposed measure.

We also consider that the first sentence of Paragraph 1.38 of the draft EM should be updated to clarify that all of the other conditions of the proposed measure need to be met.

Need for timely ATO guidance

The Tax Institute is of the view that timely guidance products from the ATO are crucial to ensure that taxpayers are able to understand and comply with their taxation obligations under this measure. The measure has significant aspects of uncertainty that need to be resolved promptly to ensure that affected taxpayers can implement the appropriate record keeping mechanisms and satisfactorily demonstrate their compliance with the proposed requirements.

Ideally, ATO guidance should accompany the release of the law measure. To enable this to occur, we recommend that the Treasury and ATO work collaboratively under the new guidance process that was implemented in 2022. We also consider that professional bodies and subject matter experts should be engaged in the early stages of the development of the guidance to ensure that it is practical and appropriate for the measure.

Commencement date

We consider that the commencement of the measure should be delayed to 1 July 2024. The proposed measure contains significant complexity and new compliance challenges for taxpayers. There are only approximately 2 months before the proposed start date of 1 July 2023. As outlined above, there are a number of aspects of the measure which require refinement and further work. Further, supporting guidance material from the ATO is necessary to ensure that taxpayers understand how the ATO intends to interpret the proposed measure and how to practically comply. This will require an investment of time and resources by the Treasury, the ATO, and taxpayers. Given these challenges and constraints, it is unlikely that this will be achievable by 1 July 2023.

The Tax Institute considers that as a matter of good tax law and policy, it is beneficial for the system as a whole to ensure the law and guidance is sound and robust, and taxpayers are provided reasonable time to get across the new measure before it is implemented. This approach is to be preferred over a rushed process to pass and implement the measure which will undoubtedly require tweaks and amendments in the future and give rise to an undue compliance burden on affected taxpayers.