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Tax Alert

Australian Treasury releases updated Exposure Draft Bill to deny deductions for payments relating to intangible assets made by significant global entities to low-tax jurisdictions

At a glance

- Rule will apply to payments made on or after 1 July 2023.
- Substantive requirements have not changed materially.
- Definition of low corporate tax jurisdictions has been clarified.
- Consideration given for amounts which have otherwise been subject to tax at a rate of 15%.
- No specific consideration of Pillar 2 minimum taxes.
- Royalty withholding tax amounts will be considered in determining the amount denied.
- Introduction of a new penalty should the rule apply to deny a deduction.
- How EY can help.

Updated exposure draft legislation (updated ED) to implement a new anti-avoidance rule has been released by Treasury. The updates have considered feedback provided during the consultation phase, but the rules will apply to payments made on or after 1 July 2023.

Under the proposed measure, the rule will deny a deduction for payments that a significant global entity (SGE) makes to associates that are attributable to a right or permission to exploit an intangible asset if, due to the arrangement or a related arrangement, the associate directly or indirectly derives income from exploiting those or related intangible assets in a low corporate tax jurisdiction.

Treasury has considered the feedback provided by consultees during the consultation phase and has made significant updates to the proposed measure although the substantive requirements remain largely the same.

Key highlights

- The rule continues to apply to payments made on or after 1 July 2023 although the law is not anticipated to be introduced into Parliament until after 31 July 2023.
- The broad definitions of intangible assets and exploitation have been retained as has the broad scope of arrangements and payments.
- The definition of a low corporate tax jurisdiction has been clarified to ensure the relevant rate is the headline corporate tax rate, with additional examples to remove uncertainty.
- New rules have been proposed which have regard to amounts which are otherwise subject to income tax of at least 15%. Such amounts will not be subject to the rule. However, no clarity is provided on the treatment of Pillar 2 minimum taxes.
- New rules have been proposed which allow for royalty withholding tax amounts to be credited against deductions which are disallowed.
- A new shortfall penalty will be introduced which would apply to any tax shortfall arising as a result of the application of the rules. This penalty would be applied in addition to the existing shortfall penalties.

Detailed analysis

Low Corporate Tax Jurisdiction Definition

The rule will deny deductibility for an amount if the SGE derives income in a low corporate tax jurisdiction from exploiting an intangible asset.

Under the original Exposure Draft (original ED), a low corporate tax jurisdiction was a foreign country where the lowest corporate income tax rate under the laws of the foreign country applicable to an SGE is less than 15% (or nil). However, there was some uncertainty in relation to the interpretation of the rules.

The updated ED makes it clear that the relevant rate of corporate income tax is the national headline corporate income tax rate, being the income tax rate applicable to income derived in the ordinary course of carrying on a business.

Deductions, offsets, tax credits, tax losses, tax treaties, concessions for intra-group dividends, exemptions for particular industries, exemptions for particular types of income, and rates that apply only to foreign residents are disregarded.

The updated ED includes two examples to illustrate the operation of the rules related to identifying low corporate tax jurisdictions. The previous ED had no specific examples. The two examples clarify that:

- Where different corporate income tax rates apply in respect of different types of income, the rate that is relevant is the rate that applies to trading income ordinarily derived from carrying on a business. The example refers to Country A which taxes trading income at 10% and passive investment income at 22%. The relevant rate in the example is 10%.
- Where different income tax rates apply for different industries, the rate that is relevant is the corporate headline tax rate. The example refers to Country B which has a headline rate of 20% and taxes manufacturing income at 10%, taxes income from oil and gas exploration at 30% and has no capital gains. The relevant rate is the 20% headline rate.

The current commentary and examples clarify the position for many jurisdictions which provide certain exemptions and concessions but have a corporate rate of 15% of more. For example, Singapore should not be considered a low corporate tax jurisdiction as defined.

However, both Ireland and Switzerland remain low corporate tax jurisdictions. The first example appears squarely directed at Ireland and its use of different rates for trading and passive income.

As we will discuss later, there is no reference in the definition to the treatment of jurisdictions which adopt a Pillar 2 Qualifying Domestic Minimum Top-Up Tax (QDMTT) where the national level corporate tax rate of the jurisdiction remains at less than 15%.

The rule will also continue to apply to deny deductions for payments to associates where income from exploiting the intangible asset is derived in a jurisdiction determined by the Minister as providing for a preferential patent box regime without sufficient economic substance in that jurisdiction. In determining a jurisdiction, the Minister may have regard to any relevant findings, determinations, advice, reports, or other publications of the OECD.

Amounts Subject to Tax

The updated ED includes concessions aimed at identifying income, derived in a low corporate tax jurisdiction, which may nonetheless be subject to a tax rate of at least 15%. Where such income can be identified, the income will be treated as derived other than in a low corporate tax jurisdiction for the purposes of the measure and thus a deduction will not be denied.

Under the original ED, where income met the substantive requirements of the rule there was no scope for amounts which would otherwise be taxed at 15% (or more) to be considered as being out of scope of the rule's operation.

The updated ED introduces a concession for the following income:

- Income which is attributable income under the Australian CFC regime (and hence will be taxed in Australia).
- Income which is subject to foreign income tax of at least 15%.

The definition of subject to foreign income tax is as defined in Australia's hybrid rules in section 832-130 of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997), with certain modifications to ensure the definition is bespoke to the proposed intangible integrity rule.

The modifications include:

- Disregarding the application of a foreign country's foreign hybrid mismatch rules.
- Considering State and municipal taxes as part of foreign income tax.

The effect of using the existing definition in section 832-130 of the ITAA 1997 is that income which is included in the tax base of another country under CFC rules which are similar to Australia's CFC rules will also be considered as subject to foreign income tax.

Considering State and municipal taxes as part of foreign income tax may mean certain income derived in Switzerland (for example) would not be subject to a denial, even though Switzerland is a Low Corporate Tax Jurisdiction based on its 8.5% federal tax rate. This will need to be determined on a canton by canton basis.

Importantly, income that is taxed under the US Subpart F rules should also qualify as income which is subject to foreign income tax of at least 15%, subject to the following caveats:

- Income which is taxed only under GILTI (and not the broader Subpart F provisions) would not appear to qualify based on the ATO's view in Taxation Determination 2022/9.

- It is expected that only the net income (after deductions other than at the parent level) can qualify.

The current Explanatory Memorandum (EM) includes an example of a country that has a national corporate tax rate of 12% (and hence is a low corporate tax jurisdiction) and also imposes corporate income tax at a state level of 10% on the same tax base as the federal level. Where the SGE can demonstrate that the payment it receives is subject to foreign income tax of 22%, the income derived will not be considered as derived in a low corporate tax jurisdiction. In order to demonstrate this, the SGE relies on income tax returns and detailed supporting workpapers and other relevant information.

Unlike the definition of low corporate tax jurisdiction (which applies to the country), this concession will require taxpayers to identify the income which is subject to a particular tax rate or treatment in a foreign country. As per the example in the EM, this means being able to positively demonstrate and prove that an amount of income has been subject to tax at a rate of 15%.

Royalty Withholding Tax

Under the original ED, the operation of the rules would mean amounts which are royalties, and for which royalty withholding tax is remitted and paid to the ATO, would be denied a deduction in circumstances where the obligation to withhold remained and no credit for withholding tax was given. This would result in clear inequitable outcomes and double taxation.

The updated ED includes new rules which effectively provide a credit for withholding tax where an amount is otherwise subject to the rule and a deduction denied.

Where a deduction would otherwise be disallowed and the taxpayer has remitted withholding tax, the amount of the deduction denied will be proportionately reduced by the amount of withholding tax remitted.

In that regard where the full non-treaty withholding rate of 30% applies, no deduction will be denied. In circumstances where a treaty rate of withholding tax applies, the amount denied will be reduced by the proportion subject to withholding tax.

The current EM includes an example to illustrate the practical operation of the proportion denied where a treaty rate of 10% applies.

New Shortfall Penalty

The original EM had flagged the introduction of a new SGE penalty for the mischaracterisation of payments for intangibles.

The updated ED now contains a new SGE penalty which applies if a deduction is denied under the proposed measure. This penalty applies in addition to the existing penalties in *the Taxation Administration Act 1953* (Cth).

The effect of this is that a shortfall which arises as a result of the proposed measure will attract the existing shortfall penalties and the new proposed penalty cumulatively. Given these penalty regimes are SGE penalties, which result in the doubling of penalties, the possibility of two cumulative penalties means a quadrupling of the shortfall penalty which would arise should a deduction be denied under the rule.

The table below details the individual and combined effect of the insertion of subsections (1A) and (1C) relating to shortfall penalties:

Concept	Base penalty amount	SGE penalty (doubles base penalty)	New penalty (doubles base penalty)	Cumulative penalty
Intentional Disregard	75% of shortfall amount	150% of shortfall amount	150% of shortfall amount	300% of shortfall amount
Recklessness	50% of shortfall amount	100% of shortfall amount	100% of shortfall amount	200% of shortfall amount
Lack of reasonable care	25% of shortfall amount	50% of shortfall amount	50% of shortfall amount	100% of shortfall amount
Not a reasonably arguable position	25% of shortfall amount	50% of shortfall amount	50% of shortfall amount	100% of shortfall amount

There are also statement penalties which apply for false and misleading statements. These are also quadrupled if applied.

Pillar 2 Taxes

As mentioned earlier in this Alert, there is no reference in the updated ED to the impact of any proposed Pillar 2 minimum taxes.

It is noted that Attachment 2 of the Explanatory Memorandum to the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* (introduced into Parliament on 22 June 2023), at page 96, states that "*The interactions between the intangibles legislation and Pillar Two global and domestic minimum taxes will be considered during Australia's implementation of its global and domestic minimum taxes*."

Further, it was also noted by Treasury in the *Statement of Outcomes* from the consultation process, that the Government is further considering interactions of the intangibles measure with global minimum taxes and domestic minimum taxes.

It is unclear at this stage how and when the integrity rule will be amended to take into account Pillar 2 taxes. Given Australia's implementation date for its QDMTT is 1 January 2024, it could be several months before we see any legislation and even longer before Treasury advises how the integrity rule will deal with Pillar 2 taxes.

This means that jurisdictions like Ireland and Switzerland remain in scope of the rule at this time.

Substantive Requirements

The substantive requirements for the integrity rule to apply remain mainly consistent with the original ED. There are some changes to the wording of the proposed law and some additional commentary and examples in the current EM. This includes an additional example on related arrangements and how the rule is intended to operate.

The substantive legislative requirements have been adjusted slightly and the rule will apply where a payer makes a payment to the extent that the payment is attributable to a right to an exploit an intangible asset and:

- The payer is an SGE.
- The payer makes a payment to an entity that is its associate (whether directly or indirectly through one of more interposed entities).
- The arrangement under which the payer makes the payment (either alone or together with any other related arrangement) results in:
    - The payer (or an associate) acquiring the intangible asset or a right to exploit the intangible asset or exploiting the intangible asset.
    - An associate deriving, in a low corporate tax jurisdiction, and whether directly or indirectly through one or more interposed entities, income from exploiting the intangible asset, or a related intangible asset.

The definitions of payments, arrangements, intangible asset and exploitation remain as broad as the original ED.

There is also, importantly, some minor word changes in the current EM related to genuine distribution arrangements and the distribution of tangible assets and the tangible asset exemption. These changes suggest that there is a deliberate distinction being drawn between trademarks that are part of (i.e. embedded in) the tangible asset and trademarks that are otherwise used for branding more generally, e.g. retail branding and general marketing materials, as well as broader brand ambassadorship.

Distributors of tangible products will need to do further work and analysis to ensure they can demonstrate that their arrangements involve payments for goods, and not payments for intangible assets such as trademarks. This includes detailed functional analysis to demonstrate the activities being undertaken in Australia and the extent of the use of any trademarks and other intangible assets such as know-how and confidential information. Given the broad definition of intangible assets and exploitation, this may result in the need for taxpayers to undertake apportionment and valuation exercises.

Other Comments

While the updated ED has considered and accepted some of the feedback provided during the consultation process on the original ED, some key points have not been adopted or addressed:

- There is no carve out for substance based commercial arrangements or headquarter/parent level arrangements. This will be challenging for entities which are headquartered in a low corporate tax jurisdiction.
- There is no purpose test or consideration of objective purpose despite the rule being described as an anti-avoidance rule.
- There is no clear exclusion for distribution arrangements, insufficient clarity over the extent of the tangible good exemption, and how incidental uses of intangibles as part of distribution arrangements will be considered.
- The start date remains fixed at 1 July 2023, applying to payments made on or after this date. This provides insufficient time for taxpayers to prepare and for the ATO to prepare guidance. This is despite the fact that the proposed law will not be introduced into Parliament before 31 July 2023.
- The concept of exploitation and intangible asset remain extremely broad applying to a wide range of arrangements, including arrangements which may not have been intended to be subject to the rule.
- No guidance is provided on apportioning payments and the manner in which payments can be apportioned.
- There is a stark absence of any guidance or view on the interaction with Pillar 2 taxes.

How EY can help

- EY teams can assist groups to determine whether, and how the proposed rule applies to any payments made on or after 1 July 2023.
- EY teams can also assist clients in determining how to apportion in-scope payments.
- Clients should reach out to their client service teams or the below contacts to discuss the impact of the updated rule.

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