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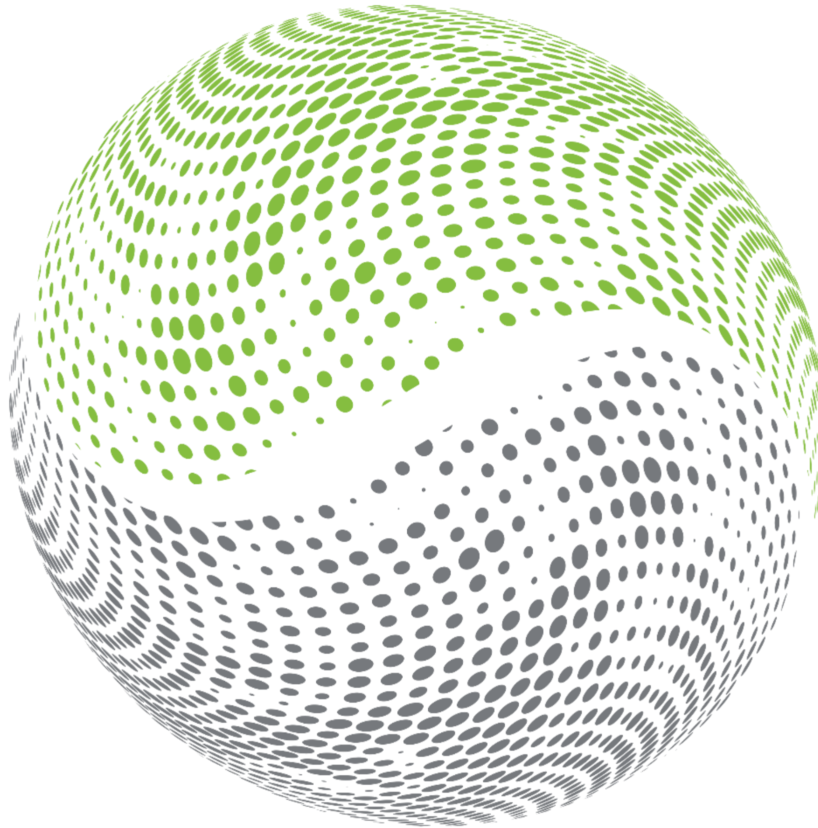

Tax Insights

Exposure draft denying deductions for payments attributable to intangible assets issued

Snapshot

On 31 March 2023, the Australian Treasury issued the Exposure Draft Treasury Laws Amendment (Measures for Consultation) Bill 2023: Deductions for payments relating to intangible assets connected with low corporate tax jurisdictions (the ED).

The ED is the third pillar of the 5 August 2022 Treasury consultation on Multinational Tax Integrity and Tax Transparency, along with proposed changes to Australia's thin capitalisation regime, as well as new tax transparency reporting rules.

Broadly the ED will introduce an anti-avoidance rule whereby tax deductions for payments attributable to the exploitation of intangible assets made by a significant global entity (SGE), directly or indirectly, to an associate in a low corporate tax jurisdiction will be denied. The anti-avoidance rule is to apply to relevant payments made on or after 1 July 2023.

Whilst the headline rate referred to in the concept of "low corporate tax jurisdiction" is 15% (presumably set with reference to Pillar Two), the low tax concept does not take into account additional tax that may arise under existing controlled foreign company (CFC) rules or the expected global minimum tax under Pillar Two.

Overview

The anti-avoidance rule is proposed to be added into division 26 together with a new subdivision 960-L of the Income Tax Assessment Act 1997 (ITAA 1997). The measure has been drafted with an intent to apply to a broad category of payments and arrangements. The statutory object of the rule is to deter SGEs who might otherwise avoid income tax by structuring their arrangements to derive income from the exploitation of intangible assets in low corporate tax jurisdictions. In summary the rule will potentially apply to payments:

- By SGEs, being multinational groups with annual consolidated global income of at least AUD 1 billion;
- In respect of an arrangement involving a payment made directly or indirectly to an associate;
- Attributable, in whole or in part, to the exploitation of an intangible asset; and
- That result in an associate deriving income in a low corporate tax jurisdiction.

It is possible under this proposed rule for a payment to be variously subject to Australian withholding tax (although the arrangements extend beyond payments of royalties) and be subject to foreign tax (including by way of CFC rules or Pillar Two) and yet also be denied a deduction in Australia.

Noting that the anti-avoidance rule is intended to apply to payments made on or after 1 July 2023, there remains uncertainty in respect of the following:

- The intended scope of the anti-avoidance rule given the adoption of broad definitions of "payment," "intangible asset," "exploiting an intangible asset," and "low corporate tax jurisdiction;"
- The withholding tax implications for in-scope payments which are royalties;
- The extent to which Australian taxpayers will be able to trace indirect payments and other offshore aspects of relevant arrangements; and
- The appropriate method or approach to attribute value to the right(s) to exploit the intangible asset(s), and so apportion in-scope payments.

The proposed rule is subject to a consultation period which closes on 28 April 2023.

This article provides initial observations on the key features of the proposed anti-avoidance rule.

Payments and arrangements

The rule applies to payments under an extremely broad category of arrangements. It includes arrangements where a payment or credit is made, or a liability is incurred that is attributable to a right to exploit an intangible asset and results in the payer or associate acquiring an intangible asset, acquiring a right to exploit an intangible asset, or otherwise exploiting an intangible asset.

The reference to "arrangement" and "related arrangement," referring to the existing definition in subsection 995-1(1) of the ITAA 1997, is said to allow for an objective examination of all relevant factors and does not require the relevant payment to be confined to a single agreement or contract. The broad definition is intended to capture a variety of ways in which intangible assets can be acquired and exploited within an SGE group.

The measure applies to deny a deduction "to the extent that the payment is attributable to a right to exploit an intangible asset." The use of "to the extent" contemplates the need to apportion one or more payments often in scenarios where the arrangement involves a single consideration amount in exchange for multiple assets and/or services. Example 1.1 of the draft explanatory material, although recognising the need to apportion a payment amount, does not offer any suggestions as to how this apportionment might be performed.

In respect of indirect payments (i.e., payments through any number of entities), the draft explanatory material states that a strict tracing of the flow of funds is not necessary and it is not necessary to

demonstrate that each subsequent payment follows the former. The rules are intended to operate where it can be identified that a payment exists between each entity. The absence of a tracing rule will likely require taxpayers to investigate global supply chains to ascertain whether a payment is within scope.

Intangible assets

The definition of "intangible assets" for the purposes of this anti-avoidance rule is broad. It applies to those “things” that are used, supplied, or received under the section 6(1) definition of royalty in the Income Tax Assessment Act 1936 (other than paragraph (b)), but it also extends well beyond royalty-type assets or “things” to a wide range of intangible assets. The measure applies to all of the following:

- Intangible assets within the ordinary meaning of that term;
- In accordance with the existing definition of royalty in subsection 6(1):
    - Copyright, patent, design or model, plan, secret formula or process, trademark, or other like right;
    - Scientific, technical, industrial, or commercial knowledge or information;
    - Visual images or sounds in television broadcasting; and
    - Motion picture films;
- A right in respect of any intangible asset to which the section applies; and
- Anything prescribed by the regulations.

The draft explanatory material further provides a list of assets to which the rule is said to apply. The list includes intellectual property, copyright, access to customer databases, algorithms, software licenses, licenses, trademarks, patents, access to a server as well as leases, licenses, or other rights over assets.

The rule does not apply to rights in respect of tangible assets, interests in land, or financial arrangements to which division 230 of the ITAA 1997 (TOFA) applies. Specifically, “industrial, commercial or scientific equipment” referred to in paragraph (b) of the definition of royalty in subsection 6(1) is excluded from the scope of intangible asset. However, and as noted with respect to the examples noted below, arrangements and payments in connection with tangible assets may nonetheless be taken to be attributable, to an extent, to an in-scope intangible asset.

The adoption of a broad category of relevant payments, arrangements, and broad definition of "intangible asset," will require SGEs to identify valuable intangible assets with specificity within their global groups. Noting the commencement date, SGEs may not be aware that current payments may be attributable, in some portion, to a relevant intangible asset and/or whether relevant income is derived by an associate in a low corporate tax jurisdiction.

Exploitation

The deduction for the payment will be denied to the extent that it is attributable to the right or permission of the SGE, or another entity, to exploit an intangible asset, or otherwise involves exploiting an intangible asset. The phrase "exploiting an intangible asset" also takes a broad meaning, including marketing, selling, and distributing the intangible asset.

However, exploiting an intangible asset also includes a low threshold activity of "do[ing] anything else in respect of the intangible asset." The draft explanatory material states that the rule applies to a broader range of circumstances than "use of the intangible asset." The rule is stated to apply to a "permission to exploit an intangible asset" and in such circumstances the rights acquired might not rise to the level of legally enforceable rights, rather they may be implicit or a mere understanding between the parties.

The broad definition of exploitation will require SGEs to review many payments to determine whether there is use or permission to use intangible assets, irrespective of whether the use or permission is documented.

Low corporate tax jurisdiction

A critical consideration is whether the arrangement results in income being derived in a low corporate tax jurisdiction. A low corporate tax jurisdiction is one where the lowest corporate income tax rate under the laws of that foreign jurisdiction, applicable to an SGE, is less than 15% or nil. When determining the corporate income tax rate, one is to disregard deductions, offsets, tax credits, tax losses, tax treaties, and concessions for intra group dividends, and tax rates that only apply to foreign residents. The draft explanatory material states that only national level corporate tax is relevant for determining whether a foreign country is a low corporate tax jurisdiction.

As presently drafted, the scope of low corporate tax jurisdiction is extremely broad. Notwithstanding that the general rate of corporate tax may be say 25%, the relevant rate will be:

- Taken to be nil if no income tax is payable on a particular amount of income. For example, if a jurisdiction has an exemption from tax on certain items, that appears to result in the relevant rate for the jurisdiction being nil, irrespective of whether that exemption is relevant to the arrangement; or
- If the jurisdiction has "different rates of income tax for different types of income:" the lowest such rate, again irrespective of whether that different rate is relevant to the arrangement.

On that basis, many jurisdictions that would not generally be thought to be low corporate tax jurisdictions appear to be in scope.

Further, the testing does not have any regard to whether the income so derived in a low corporate tax jurisdiction is otherwise taxed at a higher rate in another jurisdiction, including where there may be a CFC-type inclusion or where amounts are subject to the proposed income inclusion rule under Pillar Two. This can be contrasted with the targeted integrity rule in relation to interest in subdivision 832-J which expressly takes CFC top-up tax into account (refer s835-725(4)).

There is also scope for certain jurisdictions with patent box regimes to be treated as a low corporate tax jurisdiction. The minister has a discretion to determine a foreign jurisdiction to be a low corporate tax jurisdiction 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. Such a deeming of the jurisdiction as a low corporate tax jurisdiction would appear to apply irrespective of whether the relevant income derived is within scope of the patent box regime.

Associates

The rules refer in numerous cases to associates, such as:

- "a payment you make to your associate (the recipient);"
- "you or an associate of yours" acquires or exploits the intangible asset; and
- "the recipient or another associate of yours" derives income.

This aspect will rely upon the extremely broad definition of associate in section 318. Whilst this test applies to controlled and commonly controlled entities, the concept of associate extends beyond such circumstances to entities that are relevantly "sufficiently influenced" by another. As a result, a 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.

Withholding tax

The draft explanatory material states that the rule is designed to deter SGEs from avoiding income tax, including withholding tax. One of the concerns of in-scope arrangements is the "mischaracterisation" of payments which "results in no withholding tax being paid."

On the other hand, the rule also appears to equally apply where a royalty payment is made to a foreign associate and withholding tax is appropriately withheld and remitted as required under the Assessment Act and relevant treaty (if applicable). The rules do not take this into account as a relevant factor. That is, while the rules can apply to payments attributable to intangible assets that are beyond the scope of royalty, they also apply to payments attributable to intangible assets within the scope of royalty. The due payment of

royalty withholding tax appears to be an irrelevant factor: such a payment will also be treated as non-deductible if the other relevant conditions are met.

No purpose test

There is no purpose test in the rules. The measure adopts a results-based approach in two instances. Part of the testing is that:

- The relevant acquisition or exploitation of the intangible asset is "as a result of the arrangement;" and
- The arrangement or the acquisition or exploitation of the intangible asset "results in" an associate deriving income.

Examples

The draft explanatory material includes example 1.1 (at paragraph 1.32) dealing with a relatively straightforward case of importing, marketing, and selling tangible goods (clothing and shoes). The example nonetheless concludes that the Australian entity both uses a trademark and has been granted a sublicense to use the trademark. To that extent, payments made by the Australian entity are non-deductible.

There are further narrative explanations of supply and distribution arrangements in paragraphs 1.31-1.32 and 1.47, which also demonstrate the long reach of the proposed measure.

What should taxpayers do?

The proposed rule requires SGEs to review a wide range of payments made to related party and associate entities. Where the immediate, intermediate, or ultimate recipient of payments is in a low corporate tax jurisdiction, the review should consider the identification of:

- Relevant intangible assets within a group;
- Relevant exploitation of such assets;
- Relevant arrangements and relevant payments made attributable to such exploitation and such assets; and
- Income derived by an associate as a result of relevant arrangements; where the immediate, intermediate or ultimate recipient of payments is in a low corporate tax jurisdiction.

Where payments are received in a low corporate tax jurisdiction, taxpayers should consider to what extent any part of that payment relates to exploiting an intangible asset—it is not enough that the payment is not characterised as a royalty in legal form. This analysis may also necessarily require the identification, with specificity, of intangible assets owned by the associate in the low corporate tax jurisdiction that are being exploited by the Australian taxpayer.

Next steps

Treasury is seeking submissions on:

- The ED and ED explanatory materially generally; and
- Priority issues that would inform the Australian Taxation Office's administrative approach and public advice and guidance on this measure.

Treasury is also seeking stakeholder views regarding a shortfall penalty provision. The penalty is intended to address behaviour where SGEs mischaracterise payments in an attempt to avoid income tax, including withholding tax.

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