Deloitte.

18 July 2022
Australia 2022/09

Tax Insights

Update on EBITDA interest and royalty measures

Snapshot

On 14 July 2022, the Parliamentary Budget Office (PBO) released the "2022 Election commitments report". The PBO Report incorporates costings of all the election commitments of each party, including further detail in relation to the Labor Party proposals to:

- Introduce an EBITDA interest restriction rule (the EBITDA interest measure); and
- Deny deductions for certain royalty payments (the royalty measure).

The PBO Report provides some further insights into the scope of the measures, in addition to the very limited information provided prior to the election. Indeed, many unanswered questions arise from the PBO Report. The reality remains that the detail on these measures is yet to emerge, and as yet, there is no consultation process or timeline announced for the interest or royalty measure.

The PBO costings exercise is a complex task. Two aspects of the PBO approach are noted below:

> "PBO costings are an assessment of the financial impact of a proposed election commitment on the budget. They estimate how much an election commitment, if implemented, would change the budget surplus or deficit as presented in [Pre-election Economic and Fiscal Outlook].
>
> These costings take into account the expected direct behavioural responses to the proposed policy change by people (or other entities) who are directly affected by the policy wherever those responses are likely to have a significant impact on the cost of a proposal."

This Tax Insights addresses the observations from the PBO Report in relation to the EBITDA interest and royalty measures.

EBITDA interest measure

Announcement

- This measure was originally announced on 27 April 2022 as part of the Labor Party "Plan to ensure Multinationals Pay Their Fair Share of Tax"[1]. It is proposed to be effective from 1 July 2023.

- The April 2022 announcement was as follows:

  "Limiting debt-related deductions by multinationals at 30 per cent of profits, consistent with the OECD's recommended approach, while maintaining the arm's length test and the world wide gearing ratio

  - **From 1 July 2023** we will adopt the OECD's recommended approach for debt deductions within the allowed range to limit net interest expenses to **30% of profits**, measured using taxable earnings before interest, taxes depreciation and amortisation.

  - We will ensure we are targeting tax minimisation and firms may be able to make further deductions if they can substantiate those under the **arm's length test** or **worldwide gearing ratio test**".

- The proposed Australian regime **goes beyond** the OECD Model in that it also expressly contemplates an arm's length test, in addition to the OECD recommended approach of a fixed ratio (% of EBITDA) and an optional worldwide test.

---

[1] Labor's Plan To Ensure Multinationals Pay Their Fair Share Of Tax , https://jimchalmers.org/latest-news/media-releases/labor-s-plan-to-ensure-multinationals-pay-their-fair-share-of-tax/

PBO Report and observations

- The PBO Report describes the EBITDA interest measure as **limiting debt related deductions by multinationals**.
- The PBO Report shows positive tax collection impact of $1.45B over the forward estimates (to 2025-26) and $5.9B over the medium term to 2032-33.
  - As per the costings approach noted above, this represents additional revenue as against existing Budget forecasts based on existing policy settings, relevantly being the current thin capitalisation rules.
  - The initial positive tax collection impact is in FY2024-25 ($0.94B), reflecting reduced tax deductible interest in FY2023-24.
  - The average positive tax collection impact is approximately $0.65B per year.
- The reference to "multinationals" suggests the scope of the EBITDA interest measure may mirror the scope of the existing thin capitalisation regime, which broadly applies to Australian entities that operate internationally, Australian entities that are foreign controlled and foreign entities that operate in Australia.
- The PBO Report confirms that where a taxpayer fails the fixed ratio 30% EBITDA interest restriction limitation, it will potentially be able to obtain further deductions under the worldwide gearing test or the arm's length test, where either of those tests permits interest deductions in excess of 30% of EBITDA.
- There is no indication as to whether there will be a carry forward of denied interest deductions or unused capacity. This is a critical policy matter.
- The PBO Report notes as a costing assumption:
  - "Companies that would be denied deductions under the new limit on net interest expenses would instead seek to utilise the world-wide gearing ratio or the arm's length test and that 50% of deductions denied under the net interest expenses test would be allowed under the worldwide gearing ratio or arm's length test."
- We understand this to be a costing assumption only and not a statement of policy. That is, we believe the PBO is effectively saying that in some cases where the taxpayer fails the 30% EBITDA limitation, the worldwide gearing test and the arm's length test will <u>not</u> (having regard to the relevant facts and circumstances) provide a better result, whilst in other cases, the worldwide gearing test or the arm's length test will permit a deduction that would otherwise be disallowed under the 30% EBITDA limitation. We do not understand this to be saying that the worldwide gearing test or the arm's length test will be constrained in some way.

Royalty measure

Announcement

- This measure was originally announced on 27 April 2022 as part of the Labor Party "Plan to ensure Multinationals Pay Their Fair Share of Tax". It is proposed to be effective from 1 July 2023.

- The April 2022 announcement was as follows:

  "Limiting the ability for multinationals to abuse Australia's tax treaties when holding intellectual property in tax havens

  - Some multinationals "treaty shop" to funnel payments into tax havens with low tax rates.

  - We will limit the ability of large multinationals to abuse Australia's tax treaties while holding intellectual property in tax havens from 1 July 2023.

  - Only transactions that are subject to the "sufficient foreign tax test" aspect of the Diverted Profits Tax or involve a harmful tax preferential regime would be affected.

  - Deductions for these transactions would be denied unless firms can substantiate to the Commissioner of Taxation that the royalty payments are not for the dominant purpose of tax avoidance".

PBO Report and observations

- The PBO Report summarises the policy as follows:

  - "Deny tax deductions for the use of intellectual property when payments are made to a jurisdiction subject to the 'sufficient foreign tax test', as outlined in Section 177L of the *Income Tax Assessment Act 1936*, or where the jurisdiction houses intellectual property in a tax preferential patent box regime".

- The PBO Report describes the royalty measure as **tax havens integrity**. As is evident below, the measure is not limited to payments to jurisdictions that would traditionally be regarded as tax havens, but is much broader and for example, it is contemplated that payments to the United Kingdom will be in scope. Further, the measure does not appear to be limited to arrangements that would typically be thought of as "treaty shopping", as referred to in the April 2022 announcement.

- The PBO Report shows positive tax collection impact of $0.44B over the forward estimates (2025-26) and $1.8B over the medium term to 2032-33.

  - The initial positive tax collection impact is in FY2024-25 ($0.29B), reflecting reduced tax deductible royalties in FY2023-24.

  - The average positive tax collection impact is approximately $0.2B per year.

- **Scope of payer**: The April 2022 announcement refers to "large multinationals". Further, the PBO costing assumptions make mention of "significant global entities (SGEs)". Whilst it is not clear, it is expected that this measure will apply only to SGEs.

- **Scope of payment**: The PBO costings are based on in-scope royalties being those payments which are in respect of "copyright, patent, design or model, plan, secret formula or process, trademark, or other". This description is broadly comparable to paragraph (a) of the section 6(1), *Income Tax Assessment Act 1936* definition of royalty, which refers to payments for the use of or the right to use "any copyright, patent, design or model, plan, secret formula or process, trademark, or other <u>like property or right</u>". Further, the PBO Report refers to payments "for the use of intellectual property".

- It appears therefore that the measure will apply only to payments within paragraph (a) of the section 6(1) definition of royalty. By inference, other payments within the section 6(1) definition of royalty (eg, payments for the use of industrial, commercial or scientific equipment) appear to be outside the scope of the measure.

- The PBO description is broader than the April 2022 announcement in a number of important respects, in particular, with respect to the role of **purpose** and whether it is limited to arrangements involving **harmful** tax regimes.

- We assume that the April 2022 announcement continues to be the relevant and most authoritative description of the royalty measure, although it is evident that there are many aspects of the policy outline that remain to be clarified.

- With respect to **purpose**: The April 2022 announcement contemplated that the denial would not apply where "firms can substantiate to the Commissioner of Taxation that the royalty payments are not for the dominant purpose of tax avoidance". This is not mentioned in the PBO Report.

- It is noted that the similar measure announced by the Labor Party prior to the 2019 election stated that the measure would be limited to payments to a related party[2]. The 2022 policy is not so restricted.

- A payment to an unrelated party would be unlikely to have a dominant purpose of tax avoidance. Whether a payment to a related party has a dominant purpose of tax avoidance will depend upon the facts and circumstances.

- Harmful versus non-harmful tax regimes: The April 2022 announcement contemplated that the denial would be targeted at payments to (inter alia) a "**harmful** tax preferential regime". By contrast, the costing assumptions in the PBO Report contemplate that the measure will apply to payments to **all** "intellectual property tax-preferential regime[s], such as intellectual property box regime[s]", without limiting the scope to "harmful" regimes.

- The costings proceed on the basis that payments to all of the following countries will be regarded as in-scope payments benefitting from a tax preferential patent box regime:

    - Belgium, Cyprus, France, Hungary, India, Ireland, Israel, Italy, Luxembourg, Malta, Netherlands, Portugal, Singapore, the Slovak Republic, Slovenia, Spain, Switzerland, Turkey, and the United Kingdom.

- In relation to the "sufficient foreign tax test" which is to be imported from the Diverted Profits Tax (DPT), the PBO costings proceed on the basis that the royalty measure will apply to all "countries where the corporate tax rate is below 24%". However, the DPT sufficient foreign tax test is based on the increased foreign tax liability that results from the scheme, and is not limited to simply

[2] https://www.andrewleigh.com/labor_will_crackdown_on_loopholes_for_multinationals_media_release

looking at the headline corporate tax rate. As a result, the PBO costings may understate the revenue impact of this measure.

- There is no mention in the April 2022 announcement of the impact (if any) on the withholding provisions. It would appear that whilst the measure can deny a tax deduction for in-scope payments, such payments will continue to be exposed to withholding tax, subject to the effect of any relevant tax treaty.

- There are already multiple regimes that could be applied against the arrangements that appear to be in scope of this announcement: Part IVA generally, the Diverted Profits Tax (which imposes tax at 40%), transfer pricing, the beneficial ownership test in Article 12 (Royalty) of relevant tax treaties and the "principal purpose test" that is reflected in most of Australia's tax treaties (either directly in the relevant treaty or by virtue of the impact of the Multilateral Instrument). It is not clear how the proposed new royalty measure will interact with these other regimes.

- Further, this measure will continue to put the spotlight on the precise boundaries of a "royalty", and whether particular payments fall within the scope of paragraph (a) of the section 6(1) definition of royalty

- Much remains to be clarified regarding this measure.

Next steps

Both the EBITDA interest measure and the royalty measure involve complex law change and potentially significant impacts for many taxpayers. Both measures start in less than 12 months. It is evident from the above that many questions remain about the precise scope of the two measures. There remain many significant policy measures to clarify.

For example, in our Tax Insights Changes to debt deduction rules, 1 June 2022, we identified 11 important questions that will be key to determining the scope and impact of the EBITDA interest measure. Further, there are many uncertainties as to the precise scope of the royalty measure.

It will be important for effective and thorough consultation to take place on both these measures as the Government works through policy issues, law design issues and implementation.

18 July 2022

Contacts

Mark Hadassin
Partner
Tel: +61 2 9322 5807
mhadassin@deloitte.com.au

Cindy Perryman
Partner
Tel: +61 3 8486 1231
cperryman@deloitte.com.au

Amelia Teng
Partner
Tel: +61 3 8486 1118
amteng@deloitte.com.au

Peter Radlovacki
Partner
Tel: +61 2 8260 4243
pradlovacki@deloitte.com.au

Scott Bailey
Partner
Tel: +61 2 9322 7171
scbailey@deloitte.com.au

Claudio Cimetta
Partner
Tel: +61 3 9671 7601
ccimetta@deloitte.com.au

Manu Sriskantharajah
Partner
Tel: +61 3 9671 7310
msriskantharajah@deloitte.com.au

David Watkins
Partner
Tel: +61 2 9322 7251
dwatkins@deloitte.com.au

Jonathan Schneider
Partner
Tel: +61 8 9365 7315
joschneider@deloitte.com.au

Jacques Van Rhyn
Partner
Tel: +61 7 3308 7226
jvanrhyn@deloitte.com.au

Sharon Murray
Partner
Tel: +61 3 9671 7939
sharmurray@deloitte.com.au

Chris Ferguson
Partner
Tel: +61 3 9671 8638
chrferguson@deloitte.com.au

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the 'Deloitte Network') is, by means of this publication, rendering professional advice or services.

Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

About Deloitte
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited ("DTTL"), its global network of member firms, and their related entities. DTTL (also referred to as "Deloitte Global") and each of its member firms and their affiliated entities are legally separate and independent entities. DTTL does not provide services to clients. Please see www.deloitte.com/about to learn more.

Deloitte is a leading global provider of audit and assurance, consulting, financial advisory, risk advisory, tax and related services. Our network of member firms in more than 150 countries and territories serves four out of five Fortune Global 500®companies. Learn how Deloitte's approximately 286,000 people make an impact that matters at www.deloitte.com.

About Deloitte Asia Pacific
Deloitte Asia Pacific Limited is a company limited by guarantee and a member firm of DTTL. Members of Deloitte Asia Pacific Limited and their related entities provide services in Australia, Brunei Darussalam, Cambodia, East Timor, Federated States of Micronesia, Guam, Indonesia, Japan, Laos, Malaysia, Mongolia, Myanmar, New Zealand, Palau, Papua New Guinea, Singapore, Thailand, The Marshall Islands, The Northern Mariana Islands, The People's Republic of China (incl. Hong Kong SAR and Macau SAR), The Philippines and Vietnam, in each of which operations are conducted by separate and independent legal entities.

About Deloitte Australia
In Australia, the Deloitte Network member is the Australian partnership of Deloitte Touche Tohmatsu. As one of Australia's leading professional services firms. Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, and financial advisory services through approximately 8000 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit our web site at https://www2.deloitte.com/au/en.html.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Asia Pacific Limited and the Deloitte Network.
© 2022 Deloitte Touche Tohmatsu.