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Re: Comment Letter on the Exposure Draft for Multinational tax integrity – denying deductions for payments relating to intangible assets connected with low corporate tax jurisdictions

The National Foreign Trade Council (the "NFTC") is pleased to provide written comments on the Australian Government's Exposure Draft for Multinational tax integrity – denying deductions for payments relating to intangible assets connected with low corporate tax jurisdictions (the "Exposure Draft").

The NFTC, organized in 1914, is an association of U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD and the Inclusive Framework in establishing and maintaining international tax norms that provide certainty to enterprises conducting cross-border operations. We understand Australia's stated goal of preventing large multinationals from claiming tax deductions for payments relating to intangibles connected with low corporate tax jurisdictions. The NFTC welcomes the opportunity to provide written comments on the Exposure Draft.

General Comments

The Exposure Draft provides an anti-avoidance measure designed to deter multinationals from circumventing income tax by structuring their business to earn income from exploiting intangible assets in low-tax jurisdictions and at the same time taking a tax deduction in Australia. However, unlike other anti-avoidance rules in Australia, there is no principal purpose test or substance-based carve-out, and instead per-se disallows payments made to so called "low-tax" jurisdictions. The anti-avoidance rule does this by generally disallowing payments for the exploitation of intangibles used in the Australian market made directly or indirectly to a jurisdiction with a rate of tax of 15 percent or less. We urge that any anti-avoidance measure include a principal purpose test and substance-based carve-out, so it does not inadvertently capture bona fide commercial arrangement or structures that contain economic substance.

NFTC previously expressed our concerns with unilateral actions taken by a country in violation of the global agreement on Pillar Two reached in June 2021. This agreement was endorsed by Australia. An important part of the Inclusive Framework ("IF") agreement is the standstill and roll back of unilateral measures. Although details about what constitutes a "unilateral measure" have yet to be released, some of the proposals in the Exposure Draft may fall under the definition of extraterritorial measures. They thus would appear to go against the spirit of the agreement. Advancing such an approach may harm trust in the OECD and negate any enhanced certainty that the IF has committed to achieving through the pillars project.

Given the IF agreement, we encourage the Australian Government to reconsider bringing any such additional measures at this time. This is particularly true due to Australia's comprehensive existing tax framework as well as the suite of recently enacted tax reforms that address the concerns described in the Exposure Draft. Any new legislation, such as the Exposure Draft, may create risk of duplicating the numerous control measures that may already exist under the Australian tax system. Due to the on-going work of Pillar Two, it seems unnecessary to implement the proposal as contemplated in the Exposure Draft. Additionally, due to differences in definitions, especially in regard to Australia's approach to measuring 15 percent, this proposal will result in double taxation under Pillar Two. The combination of the QDMTT, the IIR, and the UTPR should ensure no multinational is taxed below 15 percent on a jurisdictional basis. However, the Australian royalty disallowance rules do not give effect to Pillar Two's 15 percent minimum tax, a UTPR and the royalty disallowance could apply to the same stream of income. This goes against the goals of taking a coordinated approach and mitigating double taxation.

Under the existing Australian framework, the ATO robustly enforces the arm's length principle in reviewing related party transactions. Existing disclosure requirements provide the ATO with adequate information to understand a group's functions, assets, and risks including the location of the DEMPE functions outside of Australia. Under existing rules, the ATO can make adjustments in the event that Australia is not appropriate renumerated for the activities it performs on behalf of other group members. The royalty disallowance rules are unnecessary considering the tools already at the ATO's disposal. By disallowing payments made to other group entities, including those that contain the DEMPE function, Australia will effectively cause the DEMPE activities to be taxed twice, once in Australia through the disallowed deduction and again in the jurisdiction the activities take place. When taken together with Australia's transfer pricing approach, not only can the same income be taxed twice (i.e., the outbound payment being taxed in Australia and the recipient country), but additional income can be attributed to Australia notwithstanding the disallowance of the outbound payment. In certain circumstances, this could result in the same income being subject to triple taxation.

Specific Comments

Calculation of Rate

The approach taken in the Exposure Draft to calculate the effective tax rate is very concerning. While Pillar Two looks at the effective rate of tax in a given jurisdiction taking into account withholding, state and national level of taxes, the Exposure Draft looks only to the statutory rate of tax. Under Section 960-258, a country is determined to be low tax if any of the following are true:

- The headline rate is less than 15% (with no regard to the adoption of a QDMTT);

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- If a type of income is exempt from tax, the rate is deemed zero (regardless of whether the taxpayer has the type of income that is exempt from tax);
- If there are different rates of tax for different types of income, the lowest rate (regardless of whether in fact the taxpayer avails itself of the lower rate); and
- If the Minister makes a determination that the income tax laws of a foreign country provide for a preferential patent box regime without sufficient economic substance.

With respect to the headline rate of less than 15%, ignoring subnational taxes disregards the various systems in which jurisdictions operate. For example, many jurisdictions have low federal rates of tax but the states or cantons within the jurisdiction levy additional tax utilizing the same underlying base as the federal system. Ignoring subnational taxes artificially understates the rate which a taxpayer may pay tax in a jurisdiction and frustrates the sovereignty of that jurisdiction to determine how to allocate funds from the national to the subnational level. While Australia collects national taxes and distributes them to the Australian states, other countries do not follow this approach.

Relying only on the headline rate ignores the realities of the imposition of Pillar Two. A number of jurisdictions with rates of tax below 15% have announced the introduction of QDMTTs to be implemented in connection with Pillar Two. While their “headline” rate may remain below 15%, after the application of the QDMTT the jurisdiction will in effect collect a top-up tax ensuring taxation at a 15% (or higher) rate. The EU Directive for example left open to the member states flexibility in how to implement Pillar Two (e.g., as either an increased income tax or as a parallel system). In the event that a jurisdiction exercises their sovereignty to adopt a parallel QDMTT, Australia would disallow a payment made to that jurisdiction notwithstanding that in substance, the rate of tax in the jurisdiction is 15% or greater. This is not only inconsistent with the Pillar Two rules themselves, but the good faith negotiations that Australia undertook with the OECD in negotiating Pillar Two. If Australia insists on retaining these rules in a post-Pillar Two world, we believe a better approach would be to utilize the ETR calculation in the Pillar Two model rules in which Australia helped negotiate.

With respect to 960-258(2)(d), if under the laws of a jurisdiction there is no income tax on a particular amount of income, the rate for the jurisdiction is to be treated as zero. This rule, if read in its extreme, would apply to almost all jurisdictions including Australia. For example, Australia exempts income from certain foreign PEs subject to tax in their home country where other jurisdictions would provide for a credit. Would a payment from an Australian entity to another Australian entity itself violate this rule by having types of income not subject to tax? Similarly, many jurisdictions exempt from tax interest from government bonds. It is critical that limiting principles be provided as there are few, if any, jurisdictions would meet this qualification if read literally. To the extent this rule is retained, it should be narrowed to only apply to the extent that a specific taxpayer avails themselves of an exemption regime and the disallowance should be limited solely to the amount of income exempt in the recipient jurisdiction. The rules should also make specific accommodation for payments made by or to a tax transparent entity to determine if sufficiently taxed under the rules of the payee tax jurisdiction (e.g., a payment made by an Australian branch of a foreign company where the branch income is subject to tax in the foreign jurisdiction and not the intra-company payment; or a payment made to an entity whose income is subject to tax in the hands of its members).

Furthermore, it is unclear whether the taxpayer themselves must avail of the lower rate of tax for a specific type of income or if the fact that a lower rate exists is in and of itself sufficient for a royalty to be disallowed. The interaction between 960-258(2)(e) and 960-258(2)(a) must be clarified. The rules as drafted are difficult to interpret for taxpayers and create substantial uncertainty for both taxpayers and the ATO alike. MNEs need rules to assess the impact of deductions, offsets, credits, losses, treaties, etc. only applicable when testing the headline rate.

With respect to preferential patent boxes, the rules rely on OECD principles while at the same time appear to allow the Minister by regulation to determine whether a jurisdiction provides for a preferential patent box and therefore the jurisdiction itself is considered low-tax for this purpose (regardless of whether the taxpayer in question qualifies or avails themselves of this regime). Since the imposition of BEPS Action 5, there are few, if any, harmful patent box regimes remaining. We strongly encourage relying only on OECD reporting on BEPS Action 5 for this determination. From a taxpayer perspective, there is no certainty provided as there does not appear to be any statutory guardrails on what factors the Minister would consider before making such a determination.

Definition of Intangible

As noted in previous comment letters, the Commentary on Article 12, paragraph 2, Section 8.1. provides that where a payment is in consideration for the transfer of the full ownership of an element of property referred to in the definition, the payment is not in consideration "for the use of, or the right to use" that property and cannot therefore constitute a royalty. Rather, such payments are business profits. This issue has been discussed with the ATO in the context of TD2021/D4. Notwithstanding the OECD commentary, it appears Australia has sought to implement a withholding tax by another name in the form of a denied deduction that would ignore the OECD commentary and define the use of an intangible significantly more broadly than the OECD (including, amongst other things, a right or obligation to distribute or sell products on behalf of an associate in return for consideration.) Denying a royalty deduction while imposing royalty withholding for the same payment is not equitable or fair, and results in double taxation. Further, inconsistent with the OECD commentary, software licenses, information available on a database, or general access to software is considered an intangible for this purpose regardless of whether additional rights were granted to the local subsidiary. The broad scope of definition of an intangible for this purpose and the effect of the disallowance acting as a royalty withholding tax together appear to be a workaround from the OECD Commentary and the intention of the Pillar One MLC, which was designed to halt extraterritorial taxation outside of the context of the Pillars. We recommend that the definition of intangible is narrowed to include only those items that would otherwise constitute a royalty under Australian copyright law and OECD principles.

In particular the proposed overly expansive and ambiguous references to connections with intangibles as a basis for deduction disallowance is overly ambiguous and may be applicable to virtually every sale into Australia. In substance, this appears in form to closely align conceptually with a destination-based cash flow tax, not an income tax, for any conceivable connection with intangibles.

We note that the royalty disallowance provisions seemed to be aimed directly at the digital industry, of which a significant portion of the industry are US multinationals. The proposal appears to have a discriminatory effect on the digital sector in the US, which would violate the non-discrimination provisions in Australia's international trade agreements and income tax treaties. The express focus on software and digital services raises a potential infringement of the General Agreement on Trade and Services ("GATS"), which ensures fair and equitable treatment of all participants and prohibits discrimination against a particular industry in a particular country. Knowing the bulk of companies in this industry are US multinationals, the proposal may very well violate these foundational principles contained both in the GATS and non-discrimination provisions of tax treaties.

Tracing of Payments

The Australian Royalty disallowance rules apply if a payment is made directly or indirectly through a chain of companies, any one of which is in a low tax jurisdiction. The rules, however, do not provide for any limiting principles on when a payment must continue to be traced. Instead, the explanatory materials explain that "where income is derived indirectly, strict tracing through the flow of funds is not required," in particular, it is not necessary to demonstrate that each payment in a series of payments funds the next payment or is made one after the other. *Rather, it is sufficient if the payment exists between entities.* We strongly recommend additional clarity is provided on in what instances further tracing between entities is necessary. NFTC is happy to provide examples of why additional clarity is needed and how the Exposure Draft leaves certain ambiguities with tracing of payments.

Cost Recovery

The Exposure Draft may result in an Australian level of taxation of more than 100% of the global profits derived from sales in Australia. This is the case because it allows for no cost recovery of ongoing investments made by companies to develop, enhance, maintain and protect intangibles. This issue is further exacerbated where withholding tax is otherwise imposed on outbound royalties. This results in double taxation before taking into consideration levels of taxation in other countries, which may include CFC level taxation at the multinational parent level.

Tax Treaties

There is also no mention of any exclusion for a payment to a recipient that is tax resident or subject to tax in a jurisdiction that has a valid income tax treaty with Australia. It is questionable as to whether this proposal otherwise violates the spirit, if not the explicit provisions of existing tax treaties that Australia has entered into with other countries. To avoid a clear violation of Australia's treaty obligations, there should be a carveout for payments covered by a treaty.

Conclusion

The NFTC appreciates the opportunity to comment on the proposals outlined in the Exposure Draft. We look forward to continuing opportunities for constructive engagement as the OECD/G20 Inclusive Framework finalizes the GloBE Model Rules and Australia implements those rules.

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