
TREASURY LAWS AMENDMENT (MEASURES FOR FUTURE BILLS) BILL
2023

EXPOSURE DRAFT EXPLANATORY MATERIALS

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Glossary

This Explanatory Memorandum uses the following abbreviations and acronyms.

| Abbreviation | Definition |
|---------------------|--|
| ITAA 1936 | <i>Income Tax Assessment Act 1936</i> |
| ITAA 1997 | <i>Income Tax Assessment Act 1997</i> |
| TAA 1953 | <i>Taxation Administration Act 1953</i> |
| SGE | Significant Global Entity |
| CFC | Controlled Foreign Company |
| OECD | Organisation for Economic Co-operation and Development |

Chapter 1: Denying deductions for payments relating to intangible assets connected with low corporate tax jurisdictions

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Outline of chapter

- 1.1 Schedule [x] of this Bill amends the ITAA 1997 to introduce an anti-avoidance rule designed to deter SGEs from avoiding income tax by structuring their arrangements so that income from exploiting intangible assets is derived in a jurisdiction where no or low corporate tax rates apply, while deductions for payments made to associates that are attributable to intangible assets are claimed by SGEs in Australia. This rule prevents the SGE from claiming tax deductions for such payments.
- 1.2 These amendments will not disallow a deduction to the extent that the income derived in the low corporate tax jurisdiction is attributed and assessed under Australia's CFC rules or is or will be subject to certain foreign income tax at a rate of at least 15 per cent.
- 1.3 Additionally, to the extent that the payment made by the SGE consists of a royalty and the SGE has satisfied its Australian withholding tax obligations in respect of that royalty, the amount of the deduction denied will be reduced to reflect the withholding tax paid.
- 1.4 This anti-avoidance rule aims to prevent large multinationals from securing an unfair tax advantage over other Australian businesses and seeks to ensure that large multinational enterprises are paying their fair share of tax in Australia.

- 1.5 These amendments operate in respect of payments or credits an SGE makes to an associate, as well as liabilities incurred by an SGE that are owed to an associate, on or after 1 July 2023.

Context of amendments

- 1.6 These amendments will deliver on part of the Government's multinational tax integrity package to address the tax avoidance practices of multinational enterprises as announced in the October 2022-23 Budget. These changes form part of the Government's commitment to ensure multinational enterprises pay their fair share of tax in Australia to help fund vital services, repair the Budget and level the playing field for Australian businesses.
- 1.7 These amendments will complement Australia's existing anti-avoidance provisions to deter tax avoidance behaviours of SGEs who exploit intangible assets to derive income in a low corporate tax jurisdiction while generating an income tax deduction in Australia.
- 1.8 SGEs have significant scope as to how they structure their businesses. Some SGEs have organised their functions and assets in such a way that enables subsidiaries to be charged for the use of services or assets within the group. Where an SGE is located in Australia, these charges will generally be deductible if they are not capital expenses or denied by a specific provision of the ITAA 1997 or ITAA 1936.
- 1.9 Whilst some assets have, by their nature, particular physical locations, other assets, in particular intangible assets, are readily mobile. This allows them to be located in jurisdictions with either a low headline corporate income tax rate or a regime that preferentially taxes income from intellectual property, called a preferential patent box regime.
- 1.10 The OECD periodically assesses patent box regimes to determine if they lack sufficient economic substance requirements or are considered harmful tax practices.
- 1.11 The *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance Action 5 2015 Final Report* has indicated that a jurisdiction's patent box regime would typically be considered harmful if it provides tax concessions in that jurisdiction without requiring sufficient economic substance in the development of the relevant intangible asset there. This is because such patent box regimes facilitate uncommercial arrangements that aim to avoid income tax by exploiting intangible assets where tax concessions are available.
- 1.12 This allows for SGEs to structure their business such that income from the exploitation of the intangible assets is derived in the jurisdiction that provides the most favourable tax outcome. These amendments allow the Minister to determine, by legislative instrument, a country to be a low corporate tax jurisdiction if the Minister is satisfied such a patent box regime is harmful.

- 1.13 SGEs may also mischaracterise payments that are in substance, but not legal form, made for the right or permission to exploit an intangible asset. SGEs may enter into arrangements with associates where, although the terms of the arrangements specifically preclude the transfer of any intangible assets, or consideration for the use of intangible assets, an examination of the substance of the arrangement demonstrates that the right to exploit or permission to exploit the intangible asset is a part of the arrangement.
- 1.14 SGEs may also enter into arrangements with associates that involve the provision of services from an associate and also the right or permission to exploit an intangible asset. These arrangements might assign no value to the right to exploit the intangible asset under the arrangement, instead specifying that the consideration paid is for services.
- 1.15 In both of these types of arrangements, the mischaracterisation of the payment typically results in royalty withholding tax not being paid as the taxpayer recognises no part of the payment as being a royalty for the use of the intangible asset.
- 1.16 An examination of the substance of the whole arrangement shows that despite the express provisions of the agreement to the contrary, the right to exploit, or the exploitation of, the intangible asset is of considerable value to the Australian resident entity and assigning no value to this asset is a mischaracterisation of the true substance of the arrangement, which is more likely when dealing with associates.
- 1.17 A tax advantage is obtained where an SGE is entitled to a deduction for a payment made to an associate under an arrangement at Australia's corporate income tax rate, whilst foreign income from the exploitation of the intangible asset is derived in a jurisdiction with a much lower or no corporate income tax rate.
- 1.18 Such arrangements result in insufficient tax being paid. The ability to avoid corporate income tax in this way encourages SGEs to take advantage of the highly mobile nature of intangible assets by structuring their arrangements to ensure that income from exploiting those assets is derived in jurisdictions that deliver the most tax effective outcomes.

Summary of new law

- 1.19 Schedule [x] of this Bill amends the ITAA 1997 to introduce an anti-avoidance rule. This rule is designed to deter SGEs from avoiding income tax, including withholding tax, by structuring their arrangements so that income from exploiting intangible assets is derived in a low corporate tax jurisdiction by an associate of that SGE, while a deduction for a payment made by the SGE to an associate that is attributable to that intangible asset, or a related intangible asset, are claimed in Australia. Under these amendments, no deduction is allowable for the payment made by the SGE to its associate.

- 1.20 Where an SGE makes a payment to an associate that is attributable to a right or permission to acquire or exploit an intangible asset under an arrangement, and as a result of that or a related arrangement, income from the exploitation of those or related intangible assets is directly or indirectly derived by an associate of the SGE in a low corporate tax jurisdiction, the SGE will not be entitled to deduct an amount for that payment.
- 1.21 These amendments operate in respect of payments or credits an SGE makes to an associate, as well as liabilities incurred by an SGE from an associate, on or after 1 July 2023, under an arrangement or a related arrangement of the kind referred to above, where that arrangement (including with any other related arrangement) or the acquisition or exercise of the right results in income from the exploitation of an intangible asset, or a related intangible asset being derived in a low corporate tax jurisdiction.
- 1.22 Income will not be treated as being derived in a low corporate tax jurisdiction to the extent that the income derived in the low corporate tax jurisdiction is attributed and assessed under Australia's CFC rules or is, or will be, subject to foreign income tax at a rate of at least 15 per cent.
- 1.23 Additionally, to the extent that the payment made by the SGE consists of a royalty and the SGE has satisfied its Australian withholding tax obligations in respect of that royalty, the amount of the deduction denied will be adjusted to reflect that withholding amount.

Detailed explanation of new law

- 1.24 These amendments deny a deduction for certain payments made by an SGE where:
- the payment is made to an associate of that SGE, directly or indirectly through one or more interposed entities;
 - the payment is made under an arrangement and this arrangement, either alone or together with any other related arrangement, results in:
 - the SGE or an associate of the SGE acquiring either an intangible asset or a right to exploit an intangible asset or the SGE exploiting the intangible asset; and
 - the associate or another associate of the SGE deriving income in a low corporate tax jurisdiction, directly or indirectly through one or more interposed entities, from either that intangible asset or a related intangible asset.

To the extent that the payment made by the SGE is attributable to the right to exploit the intangible asset, the deduction will be denied.

[Schedule xx, item(s) 2, section 26-110(2) of the ITAA 1997]

- 1.25 The object of the legislation is to deter SGEs from avoiding corporate income tax in Australia and globally. No deduction for payments will be available where income from exploiting intangible assets in a low corporate tax jurisdiction is derived by an associate of the SGE. These amendments are designed to apply to existing structures, as well as to deter new structures, where the elements of the amendments are established.

[Schedule xx, item 2, subsection 26-110(1) of the ITAA 1997]

- 1.26 For the purposes of determining whether income is derived by an associate in a low corporate tax jurisdiction from the exploitation of an intangible asset to the extent that income:

- is attributed and assessed to a relevant taxpayer under the Australian CFC regime; or
- is subject to foreign income tax at a rate of at least 15 per cent

That income is taken not to be derived in a low corporate tax jurisdiction.

Where all the income from the exploitation of the intangible asset that is derived by the associate in the low corporate tax jurisdiction falls within either of these two categories, no deduction will be denied under this provision.

[Schedule xx, item 2, paragraph 26-110(4)(b) of the ITAA 1997]

- 1.27 To the extent that the payment made by the SGE consists of a royalty, that has been correctly characterised, and the SGE has satisfied its Australian withholding tax obligations in respect of that royalty, the amount of the deduction denied by subsection 26-110(2) is reduced to reflect withholding tax paid.

[Schedule xx, item 2, subsection 26-110(9) and (10) of the ITAA 1997]

- 1.28 The amendments apply in relation to credits made by an SGE to an associate, or liabilities incurred by an SGE from an associate in the same way as the section applies in relation to payments. The amendments apply to payments or credits made by an SGE to an associate, or liabilities incurred by an SGE which are owed to an associate, on or after 1 July 2023.

[Schedule xx, item 2, paragraph 26-110(5)(a) of the ITAA 1997 and item 5, application provision]

- 1.29 The section also applies where the SGE or its associate does not acquire a right to exploit an intangible asset but is nevertheless permitted to exploit the intangible asset, whether that permission is express or implied.

[Schedule xx, item 2, paragraph 26-110(5)(b) of the ITAA 1997]

- 1.30 SGE is defined in section 960-555 of the ITAA 1997. The term ‘associate’ takes its meaning as defined in section 318 of the ITAA 1936.

Payments made by SGEs to associates in connection with income from exploiting intangible assets being derived in low corporate tax jurisdictions

- 1.31 These amendments apply where a payment or credit is made, or a liability is incurred, under an arrangement or a related arrangement that results in the SGE or an associate acquiring an intangible asset or a right to exploit an intangible asset, or results in that SGE or its associate exploiting the intangible asset. It is sufficient that an SGE or its associate is permitted to exploit an intangible asset, whether the permission is expressed or implied.
[Schedule xx, item 2, subparagraph 26-110(2)(c)(i) and subsection 26-110(5) of the ITAA 1997]
- 1.32 Exploiting an intangible asset takes a broad meaning. It includes using, marketing, selling, licensing and distributing the intangible asset. It also includes a supply, receipt or forbearance in respect of the asset, if paragraphs (c), (d), (da) or (f) of the definition of ‘royalty’ in subsection 6(1) of the ITAA 1936 applies to that supply, reception or forbearance. Further, exploiting another intangible asset that is a right in respect of, or an interest in, the intangible asset, such as a licence over intellectual property, or doing anything else in respect of the intangible asset also constitutes exploiting an intangible asset.
[Schedule xx, item 2, subsection 26-110(10) of the ITAA 1997]
- 1.33 This definition is broad in order to capture the variety of ways in which intangible assets can be exploited by an SGE.
- 1.34 The term ‘arrangement’ uses the existing definition of that term in subsection 995-1(1) of the ITAA 1997. This is a broad definition and will include not just the ordinary meaning of arrangement but also an agreement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings.
- 1.35 In addition to ‘arrangement’ taking a broad meaning, the provision requires that the SGE or an associate acquires the intangible asset, the right to exploit the intangible asset, or actually exploits the intangible asset ‘*as a result of*’ the arrangement under which the payment is made. This phrase, together with the broad meaning of ‘arrangement’, ensures that it is not necessary that the payment and the acquisition of the right to exploit or exploitation of an intangible asset is provided for in the same contract. This is an objective test that requires an examination of the whole of the arrangement, including collateral contracts and legally unenforceable understandings between the parties (per the definition of ‘arrangement’ in subsection 995-1(1) of the ITAA 1997). This is intended to allow the true substance of the understanding between associates to be the relevant arrangement for this provision, which may be indicated, for example, by the conduct of the associates or otherwise.
[Schedule xx, item 2, provision(s) subparagraph 26-110(2)(c) of the ITAA 1997]

- 1.36 These amendments also apply where the right to exploit an intangible asset is acquired under an arrangement related to the one which provides for the payment from the SGE to its associate. This captures a situation where the SGE or another entity doesn't acquire any express right to exploit an intangible asset under the arrangement providing for the payment, but as a result of a common understanding between associates, has access to intangible assets. *[Schedule xx, item 2, paragraph 26-110(2)(c) of the ITAA 1997]*
- 1.37 For example, a taxpayer might enter into a distribution agreement for licences over copyright as part of an arrangement with an associate in a low corporate tax jurisdiction. This arrangement may make no mention of any intangible assets but was made on the common understanding between the parties that the associate in the low corporate tax jurisdiction would make available, for no cost and without any written or formal agreement, access to the valuable information subject to copyright that the taxpayer may use in its role as a distributor of the licences. This common understanding between the parties constitutes a related arrangement.
- 1.38 As an anti-avoidance measure these amendments are intended to have a broad application. A deduction is proportionately denied where the payment is genuinely made as consideration for other things provided the result of the arrangement under which the payment is made, or a related arrangement, is that the SGE or another entity acquires an intangible asset, a right to exploit an intangible asset or exploits an intangible asset.

Example 1.1

Blue Co is an SGE and an Australian subsidiary of Hexagon Co. Blue Co & Hexagon Co are members of a group of entities of which Hexagon Co is the global parent entity. Hexagon Co is headquartered in a foreign country. The business of Hexagon Co is the manufacture and sale of clothing and shoes. Hexagon Co licenses the right to its trademark to White Co.

White Co is an associate of Blue Co and is located in a low corporate tax jurisdiction.

White Co and Hexagon Co have a cost sharing agreement in relation to the development of various business strategies, processes and intellectual property, which includes the Hexagon Co trademark. As part of this cost sharing agreement Hexagon Co allows White Co to sub-license the trademark in certain jurisdictions including Australia.

Blue Co enters into an arrangement with White Co under which Blue Co is obliged to market and sell Hexagon Co's clothing and shoes. As part of this arrangement Blue Co is granted a sub licence from White Co to use Hexagon Co's trademark. This arrangement allows Blue Co to brand its local stores with Hexagon Co's trademark and use that trademark as part of its general marketing strategy. The agreement between Blue Co and White Co specifies

that Blue Co pay White Co a fee for management and other services. The agreement also authorises Blue Co to use any of the intellectual property necessary to fulfill its obligation to market and sell clothing and shoes. The agreement specifies that access to this intellectual property, which includes the trademark is provided to Blue Co at no cost.

The trademark is an intangible asset. Blue Co also acquires a right in respect of, or an interest in an intangible asset, being the sub licence that it has acquired to use the trademark.

As a result of the arrangement between White Co and Blue Co, Blue Co uses the trademark to brand its local retail stores where clothing and shoes are sold. The trademark is prominently displayed in all marketing material. Blue Co exploits the trademark within the meaning of exploit in subsection 26-110(10) by using the trademark to brand its shops and in its marketing material. By using the trademark, Blue Co also exploits the sub licence it has acquired. The payment made by Blue Co to White Co is income of White Co in the low corporate tax jurisdiction. This is income derived by White Co in a low corporate tax jurisdiction as a result of entering into the arrangement with Blue Co under which Blue Co exploits both intangible assets, being the trademark and the sub licence. Blue Co claims a deduction in Australia equal to the fees for management and other services

As a result of the arrangements between the parties, and despite the contract providing these intangible assets are made available at no cost, Blue Co has acquired the right to use the trademark and exploits the sub licence. White Co derives income in the low corporate tax jurisdiction, being the management and services fees from Blue Co, from exploiting its licence. To the extent that the payment of these fees is attributable to the right to exploit the trademark and the sub licence by branding its shops and using the trademark as part of its marketing, the deduction for Blue Co is denied.

Example 1.2

The Green Co is a global parent entity that has annual global income of \$1 billion or more. Green Co provides streaming services worldwide and developed and maintains sophisticated algorithms and associated technology to facilitate the delivery of streaming content. Green Co is not located in a low corporate tax jurisdiction.

Triangle Co is a member of a group of entities where Green Co is the global parent entity for that group. Triangle Co is located in a low corporate tax jurisdiction.

Green Co has entered into a cost-sharing arrangement with Triangle Co related to the development of these and future works subject to copyright. Under the arrangement, Triangle Co has the right to use and sub-license the copyrighted audio and visual content in a region including Australia.

Red Co, an SGE, is an Australian subsidiary of Green Co. It is also a member of the same group of entities, which is consolidated for accounting purposes as a single group.

Red Co entered into an arrangement with Green Co under which Red Co pays a single undissected service fee to Green Co. These services include management advice, the use of Green Co's trademark, as well as payments for the use of Green Co streaming technology to distribute content for broadcasting within Australia. As part of this arrangement, Red Co is permitted to run advertisements using Green Co's technology that are viewed by the Australian customers. Red Co receives both advertising and subscription revenues. Red Co also obtains content for streaming from other third-party sources as part of its ordinary business operations.

Separate from and unrelated to the arrangement between Red Co and Green Co, Red Co later entered into an arrangement with Triangle Co under which Red Co pays a service fee to Triangle Co and is appointed the local distribution entity in Australia. Under the arrangement, Triangle Co permits Red Co to use the audio and visual content in its business of selling streaming subscriptions to Australian customers. The contract between Triangle Co and Red Co specifies that Red Co is permitted to use this content at no cost.

Red Co is exploiting the following intangible assets:

- the Green Co trademark and the rights to use Green Co's streaming technology, and
- the copyright under the agreement with Triangle Co.

Payment to Green Co

Although a portion of the undissected service fee that Red Co pays to Green Co is determined to be attributed to Red Co's right to exploit the streaming technology and trademark, no deduction is denied under section 26-110. This is because, while income is being derived by an associate (Triangle Co) in a low corporate tax jurisdiction, this did not result from an arrangement under which Red Co acquired the rights to or exploited the streaming technology and trademark. The arrangement that resulted in the income being derived by Triangle Co is discussed below

Payment to Triangle Co

Triangle Co derives income in a low corporate tax jurisdiction being the payments made by Red Co. Therefore, to the extent that the payments Red Co makes to Triangle Co are attributable to Red Co's exploitation of the copyright over the content the deduction will be disallowed.

While the contract specifies the payment made by Red Co to Triangle Co is for its appointment as a local distribution entity, part of that payment is considered to be an embedded royalty given the ability for Red Co to use Triangle Co's copyright. Given Red Co has not satisfied its Australian withholding tax obligations in respect of this embedded royalty, the amount of the deduction that might otherwise be allowable is disallowed in full.

- 1.39 These amendments apply when the payment is made by the SGE directly to an associate, or through one or more other entities (which may or may not be located in low corporate tax jurisdictions) to the associate. This, together with the fact that the right to exploit, or the exploitation of, an intangible asset may arise under a related arrangement, ensures that SGEs cannot circumvent the operation of the section by making payments through other entities. It is also not relevant where the recipient of the SGE's payment is located.

[Schedule xx, item 2, paragraphs 26-110(2)(b) and (c) of the ITAA 1997]

- 1.40 Similarly, where income is derived in a low corporate tax jurisdiction by the recipient or another associate of the SGE from the exploitation of the intangible asset, or a related intangible asset, that income can be derived either directly from that exploitation or indirectly. Where income is derived or payments are made indirectly through one or more entities, strict tracing through the flow of funds is not required, in particular, it is not necessary to demonstrate that each payment or transfer in a series funds the next payment or transfer or is made one after the other. Rather, it is sufficient if amounts are paid or transferred between each entity.

[Schedule xx, item 2, subparagraph 26-110(2)(c)(ii) and subsection (3) of the ITAA 1997]

- 1.41 Although strict tracing is not required, it must still be the case that the income derived in the low corporate tax jurisdiction is a result of the arrangement under which the SGE makes the payment or under a related arrangement. The existence of income being derived in a low corporate tax jurisdiction that is not a result of the relevant arrangement will not attract the operation of these amendments to deny the SGE a deduction for the payment that is attributable to the right to exploit an intangible asset.

[Schedule xx, item 2, paragraph 26-110(2)(c)(ii) of the ITAA 1997]

Mischaracterisation

- 1.42 These amendments apply where under an arrangement between associates, a payment might purportedly be made for things, such as services or tangible goods, but the arrangement also results in the SGE or an associate exploiting, acquiring or acquiring a right to exploit, an intangible asset, even at no cost.

- 1.43 In these cases, the payment may be apportioned to deny a deduction to the extent that it is attributable to a right to exploit an intangible asset. Where, as a result of the relevant arrangement, an entity or its associates, acquires, acquires a right to or actually exploits an intangible asset (regardless of whether it is stated in the written contract that the payment is for services or tangible goods), a deduction for the payment will be denied to the extent that the payment is attributable to the right to exploit the intangible asset. As discussed at paragraphs #1.29 and #1.36 above, where no express right to exploit is acquired under the arrangement, but the SGE or an associate is permitted to exploit the intangible asset, the deduction will be similarly denied to the extent that it is attributable to that permission to exploit the intangible asset, whether that permission is express or implied.
[Schedule xx, item 2, subsection 26-110(2) and paragraph 26-110(5)(b)) of the ITAA 1997]
- 1.44 To the extent that payments are mischaracterised by either being described in contracts or agreements as entirely for something other than the intangible asset or the payment is not apportioned appropriately, these amendments will allow the Commissioner to look to the substance of the arrangement and the deduction will be denied for the portion that is, in substance, attributable to the intangible asset.
- 1.45 This is designed to complement the anti-avoidance nature of these amendments. Mischaracterising payments that are, at least to some extent, effectively made to acquire a right or have permission to exploit an intangible asset as payments made for other things such as services or tangible goods, will not avoid the operation of this anti-avoidance rule.

Intangible Assets

- 1.46 ‘Intangible asset’ is an expression that is used in numerous other provisions in the ITAA 1997. In those provisions, its meaning is unaffected by the extensions to and carve-outs from the types of assets relevant for this section.
[Schedule xx, item 2, subsection 26-110(6) of the ITAA 1997]
- 1.47 The term ‘intangible asset’ takes its ordinary meaning, which only captures things that are assets. It is not intended for this term to adopt a definition specifically used for accounting or transfer pricing purposes. For example, workforce synergies and other intangible assets recognised for accounting purposes that are not relevant assets are not intended to be captured by these amendments.
- 1.48 Without limiting the ordinary meaning of that term ‘intangible asset’, it is made clear that the section also applies in the same way in relation to the following:
- any copyright, patent, design or model, plan, secret formula or process, trade mark or other like property or right, as referred to in paragraph (a) of the definition of ‘royalty’ in subsection 6(1) of the ITAA 1936, as well as any ancillary and subsidiary assistance furnished as a

means of enabling the application or enjoyment of any of such property or right;

- scientific, technical industrial or commercial knowledge or information as referred to in paragraph (c) of the definition of ‘royalty’ in subsection 6(1) of the ITAA 1936, as well as any ancillary and subsidiary assistance furnished as a means of enabling the application or enjoyment of any knowledge or information;
- visual images and/or sounds received, or used in connection with television or radio broadcasting, that are transmitted to the public either by satellite or by cable, optic fibre or similar technology as referred to in paragraphs (da) and (db) of the definition of ‘royalty’ in subsection 6(1) of the ITAA 1936);
- some or all of the part of the spectrum specified in a spectrum licence as referred to in paragraph (dc) of the definition of ‘royalty’ in subsection 6(1) of the ITAA 1936);
- motion picture films, films or video tapes for use in connexion with television, or tapes used in connexion with radio broadcasting as referred to in paragraph (e) of the definition of ‘royalty’ in subsection 6(1) of the ITAA 1936)
- a right in respect of, or an interest in, an intangible asset (such as a licence or right in respect of a copyright or secret formula); and
- anything prescribed by the regulations.

[Schedule xx, item 2, subsection 26-110(6) of the ITAA 1997]

1.49 This clarifies that these amendments are intended to apply to each of these items which are mentioned in the definition of ‘royalty’ in subsection 6(1) of the ITAA 1936. However, paragraph (d) of that definition of ‘royalty’ refers to certain ancillary and subsidiary assistance that enables the application or enjoyment of other things listed in paragraphs (a), (b) and (c) of that definition. The reference to ‘paragraph (b)’ in paragraph (d) is disregarded for the purposes of determining how this anti-avoidance rule applies because paragraph (b) refers to tangible assets that are not in scope consistent with the operation of the other exceptions.

[Schedule xx, item 2, paragraph 26-110(6)(b) of the ITAA 1997]

1.50 For the avoidance of doubt, the above listed assets are specified as falling within the operation of these amendments, whether or not they are already captured within the ordinary meaning of ‘intangible asset’, such as:

- intellectual property
- copyright

- access to customer databases
- algorithms
- software licences
- licences
- trademarks
- patents
- leases, licences or other rights over intangible assets.

1.51 Given the evolving nature of intangible assets, these amendments include a regulation-making power to provide for the ability to prescribe new assets to which the section applies. This allows the Government to make timely changes to the regime. The regulations would be subject to parliamentary scrutiny, including disallowance and sunseting after 10 years.

[Schedule xx, item 2, paragraph 26-110(6)(d) of the ITAA 1997]

1.52 These amendments do not apply to tangible assets, interests in land or certain financial arrangements. This is because these types of assets are less mobile or are subject to other regulatory frameworks. The assets this measure does not apply to are:

- a right in respect of, or an interest in, a tangible asset (such as a right to use a piece of industrial equipment under a hire agreement or a right to extract minerals from the earth);
- an estate, interest or right in or over land or a right in respect of such an estate, interest or right; (such as a lease over real property)
- a financial arrangement where the Taxation of Financial Arrangement (ToFA) regime under Division 230 of the ITAA 1997 applies in relation to the gains and losses from that financial arrangement (such as a derivative where the gains and losses are brought to account under the ToFA regime);
- an equity interest or a right or obligation in respect of an equity interest, that is a financial arrangement, as referred to in section 230-50 of the ITAA 1997, for which the gains and losses are not brought to account under the ToFA regime (this ensures such equity interests are carved out regardless of the ToFA election a taxpayer has made);
- a right in respect of, or an interest in, an intangible asset that is already covered by any of the above;
- anything prescribed by the regulations.

[Schedule xx, item 2, paragraphs 26-110(7)(a) to (f) of the ITAA 1997]

1.53 It is not intended for this anti-avoidance rule to inappropriately apply to the extent that a genuine supply and distribution arrangement between associates is attributable to any of the items listed above. For example, where trade marks are printed on finished goods that are marketed and sold by an SGE to customers, this provision will not deny a deduction to the extent that the payment made by the SGE to an associate is genuinely attributed to the good and not the trade mark. To ensure these arrangements are not inappropriately caught, the provisions allow a payment to be apportioned so that the section is precluded from applying in relation to an intangible asset that is a right in respect of, or an interest in:

- a tangible asset; or
- an intangible asset to which the section doesn't apply and the payment relates to the tangible asset or other excluded asset.

[Schedule xx, item 2, paragraphs 26-110(1) and (7)(a) and (e) of the ITAA 1997]

1.54 Arrangements that are the subject of these amendments often involve several intangible assets. In particular, some of these intangible assets may be interrelated to each other, such as via the granting of a licence over an intangible asset. For example, an entity that owns a patent may grant a licence to an associate conferring the right to use that patent without being in breach of the legal protection that the patent affords the owner. That associate may grant a sub-licence to another associate. In this example, the patent, the licence and the sub-licence are all intangible assets. If any of the patent, the licence or the sub-licence are exploited such that income is derived by an associate of the SGE in a low corporate tax jurisdiction, subject to satisfying the remaining criteria of the provision, deductibility for the payment, credit or liability incurred will be denied.

Exploiting an Asset

1.55 The deduction for the payment will be denied only to the extent that it is attributable to the right, or permission, of the SGE or an associate to exploit or acquire an intangible asset. In addition, an associate must derive income in a low corporate tax jurisdiction, directly or indirectly, from the exploitation of the intangible asset or a related intangible asset under a related arrangement. This derivation must occur as a result of the arrangement or a related arrangement. For these purposes, 'exploiting an intangible asset' is prescribed to have a broad meaning.

[Schedule xx, item 2, subsections 26-110(2) and (10) of the ITAA 1997]

1.56 The phrase 'exploiting an intangible asset', in the context of these provisions is intended to be broad to capture the variety of ways that SGEs benefit from intangible assets. It captures:

- the use of, marketing, licensing, selling and distributing the intangible asset;

- the supply of an intangible asset mentioned in paragraphs (c) or (d) of the definition of ‘royalty’ in subsection 6(1) of the ITAA 1936;
- the reception of an intangible asset mentioned in paragraph (da) of the definition of ‘royalty’ in subsection 6(1) of the ITAA 1936;
- the forbearance of an intangible asset mentioned in paragraph (f) of the definition of ‘royalty’ in subsection 6(1) of the ITAA 1936;
- exploiting another asset that is a right in respect of, or an interest in, the intangible asset; and
- doing anything else in respect of the intangible asset.
[Schedule xx, item 2, paragraphs 26-110(10)(a) to (e) of the ITAA 1997]

1.57 The amendments apply to a broader range of circumstances than just the ‘use of an intangible asset’ as the ways in which intangible assets can be exploited by an SGE is equally broad. In addition, as discussed at paragraphs #1.29, #1.32 and #1.43 above, the section applies to a permission to exploit an intangible asset in the same way that it applies to a right to exploit an intangible asset. As the arrangements subject to this anti-avoidance rule are between associates, the rights that are acquired might not constitute legally enforceable rights. By extending the section to apply to a ‘permission to exploit an intangible asset’, these amendments will also apply where the ability to exploit the intangible asset is implied via the conduct of, or an understanding between, the related parties.

[Schedule xx, item 2, paragraph 26-110(5)(b) of the ITAA 1997]

1.58 By extending the section to apply to a ‘permission to exploit an intangible asset’, these amendments will also apply where the ability to exploit the intangible asset is implied via the conduct of, or an understanding between, the related parties.

[Schedule xx, item 2, paragraph 26-110(5)(b) of the ITAA 1997]

1.59 This is consistent with the provision being an anti-avoidance measure, as it is designed to capture a broad spectrum of arrangements to minimise the risk of SGEs and their associates structuring their arrangements in such a way so as to circumvent the operation of the provision. For the purposes of these amendments, examples of activities that would be considered to be within the meaning of exploiting an intangible asset are:

- the copying of an item of copyright or software;
- the issuance of a licence key or other piece of information that allows access to a piece of software or a database;
- accessing information contained on a database;
- the deploying of or accessing the output of an algorithm;

- a use of a brand, trade mark or other intangible asset that is a source of goodwill that can be used by an entity holding themselves out as a representative of that brand or group;
- a right or obligation to distribute or sell products on behalf of an associate in return for consideration from either the associate or third party customers that involves marketing, selling or distributing the intangible asset even when that intangible asset is distributed directly from the offshore associate to the customer.

Low corporate tax jurisdictions

- 1.60 Deductibility for an amount of the payment will be denied, subject to satisfying the remaining elements of the section, only if an associate of the SGE derives income in a low corporate tax jurisdiction from exploiting an intangible asset.
[Schedule xx, item 2, subparagraph 26-110(2)(c)(ii) of the ITAA 1997]
- 1.61 A low corporate tax jurisdiction for the purposes of subparagraph 26-110(2)(c)(ii) is one where the lowest corporate income tax rate under the laws of that foreign country, applicable to an SGE, is less than 15 per cent or is nil.
[Schedule xx, item 2, paragraph 26-110(4)(a) and item 3, subsection 960-258(1) of the ITAA 1997]
- 1.62 The term ‘foreign country’ in these amendments will take the same meaning as section 2B of the *Acts Interpretation Act 1901* and refers to any country (whether or not an independent sovereign state) outside Australia and the external Territories.
- 1.63 In determining the rate of corporate income tax in a jurisdiction for the purposes of determining if a jurisdiction is a low corporate tax jurisdiction, only the income tax rates applicable to income derived in the ordinary course of carrying on a business are relevant.
[Schedule xx, item 3, paragraph 960-258(2)(a) of the ITAA 1997]
- 1.64 Deductions, offsets, tax credits, tax losses, tax treaties, concessions for intra-group dividends, exemptions for particular industries, exemptions for particular types of income, and income tax rates that apply only to foreign residents are disregarded. Disregarding these items complements the reference to ‘*the rate of corporate income tax*’ in subsection 960-258(1) to clarify that it is the national headline corporate income tax rate that is relevant for the purposes of determining whether a jurisdiction is a low corporate tax jurisdiction. The reference to ‘*the laws of that foreign country*’ in subsection 960-258(1) clarifies that only national level corporate income tax is relevant for determining whether a foreign country is a low corporate tax jurisdiction. The amendments require the identification of ‘*the*’ rate of corporate income tax, not any concessional rate of income tax that could apply in that foreign country to particular taxpayers or industries.
[Schedule xx, item 3, subsection 960-258(1) and subsections 960-258(2)(b)(i) and (ii) of the ITAA 1997]

- 1.65 For foreign countries with progressive corporate income tax rates, only the highest rate will be relevant in determining whether that country is a low corporate tax rate jurisdiction. In determining the rate of corporate income tax under the laws of a foreign country, the rate income tax applicable to ordinary business income that has not been disregarded under paragraph 960-258(2)(b), is treated as nil if no income tax applies to that amount under the laws of that foreign country. Where different income tax rates apply to such income, only the lowest tax rate is relevant.

[Schedule xx, item 3, paragraphs 960-258(1)(a), (2)(c) and (d) of the ITAA 1997]

- 1.66 These provisions ensure that the amendments capture the relevant headline corporate income tax rate that ordinarily applies to the income of an SGE. However, it will not capture concessional corporate income tax rates that apply to particular taxpayers, such as on application by a particular taxpayer or rates that apply for small or medium businesses, as such rates are not relevant for an SGE.

[Schedule xx, item 2, paragraph 26-110(4)(a) of the ITAA 1997]

Example 1.3

Country A has different corporate income tax rates that apply to SGEs in respect of different types of income. Trading income, ordinarily derived from the carrying on of a business, is taxed at 10 per cent, however passive income derived from investments, such as shares or property, is taxed at 22 per cent. Country A is a low corporate tax jurisdiction under this definition as only the 10 per cent rate is relevant as that is the corporate income tax rate at which income derived in the ordinary course of business is taxed. This is so even if the SGE also has passive income that is taxed at 22 per cent.

Example 1.4

Country B has a corporate headline income tax rate of 20 per cent. Country B has a system of different income tax rates for different industries. For example, Country B taxes manufacturing business income at a rate of 10 per cent and taxes income from oil and gas exploration at 30 per cent. Country B also does not impose any taxes on capital gains.

In determining if Country B is a low corporate tax jurisdiction only the 20 per cent income tax rate is relevant. The 10 per cent rate for the manufacturing businesses is a concession for a particular industry and the no tax on capital gains is an exemption for a particular kind of income. The 30 per cent income tax rate imposed on oil and gas exploration only applies to a particular industry so it is not *the* corporate income tax rate that applies to income derived by SGEs in the ordinary course of business. Country B is not a low corporate tax jurisdiction because, the relevant corporate income tax rate is 20 per cent.

Disregarding Income from Intangible Assets that has been taxed

- 1.67 In determining if income has been derived in a low corporate tax jurisdiction by an associate, to the extent that an amount of income has been taken into account under Section 456 and 457 of the ITAA 1936 and assessed to any taxpayer as attributable income under the Australian CFC regime, that income is disregarded. In addition, to the extent that any amount of income is subject to foreign income tax at a rate of at least 15 per cent, that amount of income is also disregarded. To the extent the associate derives other income in the low corporate tax jurisdiction from the exploitation of the relevant intangible asset that is not attributed under the CFC regime or subject to foreign income tax at a rate of at least 15 per cent as outlined above, subsection 26-110(2) will still operate to deny a deduction for the payment.
[Schedule xx, item 2, paragraphs 26-110(4)(a) and (b) of the ITAA 1997]
- 1.68 In determining the rate at which income is subject to foreign income tax, these amendments use the existing definition of subject to foreign income tax in section 832-130 of the ITAA 1997. This will include all income or profits where income tax is payable under a law of a foreign country because that amount of income or profit is included in the tax base of that law for that foreign tax period. It will also include where income is attributed to a different entity by a provision of a law of a foreign country that corresponds to the Australian CFC rules under section 456 or 457 of the ITAA 1936.
- 1.69 This will include all income or profits where income tax is payable under a law of a foreign country because that amount of income or profit is included in the tax base of that law for that foreign tax period.
- 1.70 In determining the rate at which the income is subject to foreign income tax there are some modifications to the existing definition of 'subject to foreign income tax'. Specifically, the exclusion of foreign hybrid mismatch rules and municipality and State taxes from that definition under subsection 832-130(6) and paragraphs 832-130(7)(d) and (e) are disregarded.
[Schedule xx, item 2, subparagraph 26-110 (4)(b)(ii) ITAA 1997]
- 1.71 Disregarding subsection 832-130(6) will mean that if the payment is subject to foreign income tax at a rate of 15 per cent or greater because of the application of foreign hybrid mismatch rules of a foreign country it may be considered as subject to foreign tax for the purpose of determining whether income is derived by an associate in a low corporate tax jurisdiction. Subsection 832-130(6) was originally introduced to preserve Australia's right to neutralise a hybrid mismatch even where a foreign country has also done so and is not required for these amendments.
- 1.72 Disregarding paragraphs 832-130(7)(d) and (e) ensures that in determining if income derived in a low corporate tax jurisdiction is subject to foreign income tax at a rate of at least 15 per cent, State and municipal taxes will be included.
- 1.73 This ensures that general compliance costs for these amendments are minimised, as the national headline corporate income tax rate for SGEs is used, however no deduction is denied where income derived by associates in low

corporate tax jurisdictions are being taxed at a rate higher than the national headline corporate income tax rate.

Example 1.5

Country C has a federal corporate income tax rate of 12 per cent and also levies corporate income taxes at a State level of between 2 and 10 per cent on the same tax base as the federal corporate income tax rate. Only the federal corporate income tax rate is relevant for determining if a jurisdiction is a low corporate tax jurisdiction. Consequently, Country C is a low corporate tax jurisdiction.

Octagon Co is located in Country C, within a State that imposes a State corporate income tax rate of 10 per cent on the same tax base as Country C's federal corporate income tax rate. Octagon Co is a member of a group of entities that are consolidated for accounting purposes. The global parent entity of that group is an SGE.

Aus Co is an SGE located in Australia and is also a member of that same group of entities.

Octagon Co derives incomes as a result of an arrangement with Aus Co, under which Aus Co makes a payment to Octagon Co for a licence to exploit the intangible assets of Octagon Co.

Aus Co can demonstrate that the income derived by Octagon Co in Country C has been subject to foreign income tax at a rate of 22 per cent, being the aggregate of the federal and State corporate income taxes that apply. Aus Co relies on the income tax returns and supporting detailed tax working papers and other information to demonstrate this. Although the income is derived in a low corporate tax jurisdiction, Aus Co can demonstrate the income was subject to foreign income tax at a rate of 22 percent. The income derived by Octagon Co from the payment made by Aus Co is disregarded in determining if income is derived in a low corporate tax jurisdiction. Consequently, the deduction for Aus Co is not denied under section 26-110 of the ITAA 1997.

Royalty Withholding Tax

- 1.74 Where a deduction would otherwise be denied because of the operation of these amendments but the taxpayer has withheld an amount from a royalty payment and remitted it to the Commissioner as required and no other provision denies a deduction, the amount of the deduction denied will be reduced to reflect the withholding tax paid. This is to recognise Australian withholding tax has been paid in relation to that amount where an amount has been withheld and remitted to the Commissioner on that payment.
[Schedule xx, item 2, subsection 26-110(10) of the ITAA 1997]
- 1.75 This will also apply where the royalty payment is in a non-cash form and the taxpayer paid an amount to the Commissioner that is equivalent to what would

have been required if it was a payment of money equal to the market value of the benefit.

[Schedule xx, item 2, subparagraph 26-110(8)(c)(ii) of the ITAA 1997]

- 1.76 The amount of the reduction is the amount paid to the Commissioner divided by the corporate income tax rate that applies to the SGE. Therefore, where the full payment by a taxpayer to an associate is characterised correctly as a royalty and an amount is withheld from that royalty at a rate of 30 per cent and remitted to the Commissioner, provided no other provision denies the deduction, the full amount of the royalty will be deductible despite the operation of subsection 26-110(2) of the ITAA 1997. This rule applies only to the extent that the payment for which a deduction is claimed consists of a royalty and withholding tax has been remitted. If the payment for which the deduction is denied includes amounts that do not consist of a royalty, there is no reduction under this rule and those amounts may still be denied.

[Schedule xx, item 2, subsections 26-110 (8) and (9) of the ITAA 1997]

- 1.77 If the full payment by a taxpayer to an associate is characterised correctly as a royalty and the taxpayer has withheld an amount from that royalty at a rate of 10 per cent and remitted that amount to the Commissioner, as required under a double tax agreement, noting that rates may vary under a double tax agreement, the amount of the deduction is the withholding amount divided by the corporate tax rate applicable to the SGE for the income year.

[Schedule xx, item 2, subsections 26-110(8) and (9) of the ITAA 1997]

Example 1.6

Aus Co, an SGE located in Australia, makes a payment of \$130 to an associate, Rectangle Co. Both Aus Co and Rectangle Co are SGEs and members of a group of entities where Rectangle Co is the global parent entity of that group. Rectangle Co is headquartered in a low corporate tax jurisdiction.

Of the \$130 payment that Aus Co makes to Rectangle Co, \$100 is attributable to Aus Co's right to exploit copyright and consists of a royalty. Rectangle Co is located in a jurisdiction with whom Australia has a double tax agreement and the relevant royalty withholding tax rate is capped at 10 per cent in accordance with that agreement. Therefore, Aus Co withheld an amount of \$10 and remitted it to the Commissioner.

The Commissioner commences a review of Aus Co's income tax return for the relevant income tax year. As part of that review, it is determined that the entire \$130 is a payment attributable to the right to exploit an intangible asset and all the requirements for the deduction to be denied under subsection 26-110(2) of the ITAA 1997 are established.

Given Aus Co has withheld an amount of \$10 and remitted it to the Commissioner, Aus Co can claim a deduction of \$33, being the

withholding amount of \$10 divided by the applicable corporate tax rate of 30 per cent. The remaining \$97 is not deductible pursuant to subsection 26-110(2) of the ITAA 1997.

Tax Preferential Patent Box Regime

- 1.78 These amendments also 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.
[Schedule xx, item 3, subsection 960-258(4) of the ITAA 1997]
- 1.79 A patent-box regime is a regime that typically provides tax concessions, usually in the form of a concessional rate of tax, for income that is derived by the exploitation of intellectual property. A regime of this kind usually involves income that is derived from the ownership of patents and offers these concessions to encourage companies to locate and/or develop their intellectual property onshore in those countries.
- 1.80 This amendment is not designed to capture all patent-box regimes, rather it only intends to apply in respect of those regimes that provide tax concessions without requiring sufficient economic activity to develop the relevant intellectual property in the country which provides the patent box concession.
- 1.81 The OECD periodically reviews preferential tax regimes, including those focused on intellectual property, such as patent box regimes, to determine if sufficient economic substance exists. This is done through the *OECD Forum on harmful tax practices*.
- 1.82 The Minister may make a legislative instrument to determine a foreign country if the Minister is satisfied that the income tax laws of the foreign country provide for a preferential patent box regime without sufficient economic substance. This is intended to ensure that any harmful patent-box regimes are captured. The power to make a legislative instrument ensures the legislation can quickly adapt to changes in patent-box regimes in other countries or the introduction of new patent box regimes in other countries.
[Schedule xx, item 3, subsection 960-258(4) of the ITAA 1997]
- 1.83 In determining a jurisdiction, the Minister may have regard to any relevant findings, determinations, advice, reports or other publications of the Council of the OECD, such as “*Harmful Tax Practices – 2018 Progress Report on Preferential Regimes and the Harmful Tax Practices – Peer Review Results – Inclusive Framework on BEPS: Action 5*” and the most recent conclusions of the *OECD Forum on harmful tax practices* in this regard.
[Schedule xx, item 3, subsection 960-258(5) of the ITAA 1997]
- 1.84 The legislative instrument would be subject to disallowance and would sunset after 10 years and will therefore be subject to appropriate parliamentary scrutiny.

Penalties

- 1.85 These amendments also contain a doubling of the base penalty amounts where the penalty results from an application of these amendments. This is in addition

to the doubling of the base penalty amounts that already applies to a penalty of an SGE.

- 1.86 Where the penalty in question is a shortfall penalty for either a false or misleading statement or a failure to take reasonable care, the base penalty amount will be doubled to the extent that the shortfall results from the application of these amendments. The base penalty amounts will also be doubled in respect of false and misleading statements that do not produce a shortfall.

[Schedule xx, item 5, paragraphs 284-90(1C)(a) and (b) of the TAA 1953]

Consequential amendments

- 1.87 Schedule [x] of this Bill makes consequential amendments to insert a reference to this section in the list of provisions about deductions in section 12-5 of the ITAA 1997. The Bill also inserts new definitions of the terms ‘*exploit*’ an intangible asset and ‘*low corporate tax jurisdiction*’ into subsection 995-1(1) of the ITAA 1997.

[Schedule xx, item 1, section 12-5 of the ITAA 1997 and item 4, subsection 995-1(1) of the ITAA 1997]

Commencement, application, and transitional provisions

- 1.88 The amendments commence the day after Royal Assent.
- 1.89 The amendments apply to all payments made or credited or liabilities incurred after 1 July 2023.