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Per email to: MNETaxIntegrity@treasury.gov.au

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SwissHoldings Comment Letter
Exposure Draft – Treasury Laws Amendment (Measures for Consultation) Bill 2023: Deductions for payments relating to intangible assets connected with low corporate tax jurisdictions

Dear Ms Ram

SwissHoldings welcomes the opportunity to provide comments on the Government's *Exposure Draft – Treasury Laws Amendment (Measures for Consultation) Bill 2023: Deductions for payments relating to intangible assets connected with low corporate tax jurisdictions* ("Exposure Draft legislation" and/or "draft measure"). SwissHoldings represents the interests of 62 Swiss-based multinational enterprises from the manufacturing and service sectors (excluding the financial sector) such as Nestlé, Roche, Novartis, ABB, Kuehne+Nagel, Schindler and Holcim.

SwissHoldings and its members are worried that the Exposure Draft legislation (as currently drafted) would result in taxation outcomes which are not consistent with the objectives of the legislation and with current and emerging international taxation norms.

SwissHoldings specific concerns are:

- There is no substance-based exclusion or an exclusion for payments made back to an ultimate parent where the parent has economic substance, meaning that the measures (as drafted) are not consistent with their objectives as a means to combat arrangements that have been structured to avoid tax.
- The Exposure Draft legislation does not address or provide for concepts associated with the Organisation for Economic Co-operation and Development ("OECD") Pillar Two framework

which are anticipated to be adopted by many countries (including Australia and Switzerland) and is inconsistent with global measures to address base erosion and profit shifting.
- The measures can lead to triple taxation of the same amount of income due to the non-recognition of taxes imposed on payments relating to intangible assets.
- The use of multiple broad definitions in the Exposure Draft legislation results in uncertainty in respect of what arrangements are within scope. That is, our member companies are not able to reliably self-asses against it.
- Such uncertainty also applies to arrangements for the sale and purchase of goods and provision of services, whereby there is only incidental use of an intangible asset and is further compounded by comments in the Exposure Draft explanatory materials regarding 'penalties' for mischaracterisation.
- The Draft legislation is premature as not in line and in anticipation to the adoption of the OECD Pillar 2 Guidelines, hence introducing confusion and future controversy, where the OECD's primary objective with Pillar 2 was to come up with a new harmonized international tax system.

We hope this submission will be helpful and that consideration will be given to our comments and that the very least consideration is given to deferring its start date to when Australia adopts the OECD Pillar Two framework to make these rules consistent with Australia's adoption of OECD Pillar Two global minimum tax. Existing tax anti-avoidance measures already in place in Australia, such as the Diverted Profits Tax rules and the General Anti-Avoidance rules can continue to be used in the meantime to target any arrangements relating to the payment of intangibles to low tax jurisdictions where an arrangement has been structured to obtain a tax benefit.

Our summary recommendations have been included below. We further elaborate on these in Appendix A.

Final law should not apply to genuine commercial arrangements and be more targeted

The Exposure Draft explanatory materials provide that the rules are intended to *"introduce an **anti-avoidance rule** designed to deter significant global entities from **avoiding** corporate income tax **by structuring their arrangements…**"* and further states that *"it is not intended for this **anti-avoidance rule** to inappropriately apply to genuine supply and distribution arrangements between associates, where there is **no tax avoidance** behaviour."*

The Exposure Draft legislation as currently drafted however captures payments where a significant global entity ("SGE") has not structured its arrangements to avoid corporate income tax.

We submit, that in order to capture such intended payments that there is a safeguard from these rules applying, i.e. to satisfy these stated intentions, via a dominant purpose test (consistent with Australia's main General Anti-Avoidance rules) or a substance-based exclusion test (consistent with Australia's Diverted Profits Tax) or an exclusion for payments made back to a jurisdiction where the ultimate parent company of a multinational is based and has economic substance (consistent with the Australian targeted integrity rules for interest payments) or a combination of all of the above.

The definition of a low corporate tax jurisdiction should be updated

In using the headline rate of tax in a jurisdiction within the definition of a low corporate tax jurisdiction, the Exposure Draft legislation does not appear to incorporate any tax that will be paid under Pillar

Two, establishing a 15% minimum tax. We therefore recommend that the definition is updated to include any tax that is paid in a jurisdiction in reaching the 15% minimum tax threshold under Pillar Two.

We also recommend that the definition of a low corporate tax jurisdiction incorporates other taxes which might be paid in respect of the income including tax paid under controlled foreign company ("CFC") regimes, state and communal i.e. municipal taxes (as in Switzerland) as well as withholding tax.

We also recommend that there is an exclusion to the definition of a low corporate tax jurisdiction for income received by the ultimate parent entity or jurisdiction of the ultimate parent entity where there is also sufficient economic substance in that jurisdiction.

Without the exceptions noted above, multinationals will be unfairly caught up within the rules in connection to genuine commercial arrangements. This will act as a disincentive to provide valuable intangible assets to Australian companies, resulting in the potential loss of the use of intangible assets in Australia for the benefit of Australian people and Australian communities.

Incidental use of intangible assets in marketing and promoting tangible goods and/or in connection to a provision of a service should not be caught

We recognise there is no firm threshold between incidental and non-incidental use of intellectual property. However, we consider it common for intangible assets to be used in the marketing and promoting of tangible products in a highly controlled and restricted manner whereby the value of such rights is generally seen as being of a negligible amount. We recommend the final law incorporates an exclusion for the incidental use (exploitation) of intangible assets.

We thank you for your consideration of our submission and welcome the opportunity to discuss our submission with you if more information is required. Please contact Martin Hess (Martin.Hess@SwissHoldings.ch) should you have any questions or wish to discuss.

Yours sincerely,

SwissHoldings
Federation of Industrial and Service Groups in Switzerland

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APPENDIX A – Detailed Recommendations / Observations on the Draft Measure

Final law should not apply to genuine commercial arrangements and be more targeted

The Exposure Draft legislation as currently drafted appears to capture payments where a significant global entity ("SGE") has not structured its arrangements to avoid corporate income tax (i.e. the stated intention of the measure).

For example, and depending on the definition of a low corporate tax jurisdiction, SwissHoldings members have been based in Switzerland for many years (many of these members were founded in Switzerland) and have created and developed valuable intangible assets in Switzerland since that time. These intangible assets are held in Switzerland, and accordingly income is derived in Switzerland, because that is where these intangible assets have been created and developed over time, noting that these multinationals have a substantial presence in Switzerland, and many have always been Swiss based and headquartered.

We therefore submit that for the draft measure to only capture intended payments, that there is a safeguard from its application, to satisfy its stated intentions, via a dominant purpose test (consistent with Australia's main tax avoidance rules) or a substance-based exclusion test (consistent with Australia's Diverted Profits Tax) or an exclusion for payments made back to a jurisdiction where the ultimate parent company of a multinational is based and has economic substance (consistent with the Australian targeted integrity rules for interest payments) or a combination of all of the above.

Further the proposal for the measure to apply to payments by an Australian entity to an associate which may 'indirectly' result in income being derived in a low corporate tax jurisdiction for the exploitation of intangible assets is highly problematic. This is compounded by the fact that tax laws around the world are complex and subject to regular changes. Finally, we note the extremely broad definition of associate in section 318 of the *Income Tax Assessment Act 1936* which extends to entities that are relevantly "sufficiently influenced" by another and the broad manner that an 'arrangement' has been defined in the draft measure.

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. These factors place an impossible burden on the Australian entity to have visibility into the entire global operations, have an in depth understanding and monitor tax law changes around the world and even dealings with "third parties" in making assessments compounded by the need to make assessment on dealings that may not even be legal in nature. Indeed, unless the measure is redrafted such that it is more targeted by having a purpose / substance-based exclusion, we believe that our member companies will not be able to reliably self-assess against it.

Definition of a low corporate tax jurisdiction should be updated

Rate of corporate income tax

Section 26-110(11) of the Exposure Draft legislation states that *"a foreign country is a low corporate tax jurisdiction if the rate of corporate income tax under the laws of that foreign country is less than 15%".* The Exposure Draft legislation does not clarify whether the rate of corporate income tax is the statutory rate applicable at the country / federal level or is also inclusive of other state and municipal taxes (as relevant for Switzerland, canton and communal taxes which are also applied upon the income tax base). It is also submitted that to the extent to which income so derived in a low corporate tax jurisdiction is otherwise taxed in another jurisdiction, including under a CFC-type inclusion, that such circumstances are considered whether the income has been taxed at a 15% rate.

Such an approach should be applied, as the combination of these taxes reflects the true corporate tax rate applicable in a jurisdiction and/or tax applied on the income and this approach is not inconsistent with existing tax anti-avoidance measures already in place in Australia, such as the hybrid mismatch integrity rules.

Top up tax

The measure is inconsistent with the 'top up approach' that is the consensus approach to addressing tax minimisation arrangements. Further, rather than disallowing the deduction in full (in circumstances whether the whole amount is for the exploitation of an intangible assets) regard should be had to disallow a component of the deduction to the extent that there is remaining insufficient tax (i.e. to bring it up to 15%).

Many countries around the world, including Australia and Switzerland, have publicly stated that they will be adopting the OECD's two pillar solution to tackle tax avoidance associated with profit shifting, including profit shifting by means of royalty payments for the use of intangible assets. Pillar Two includes a 15% global minimum effective tax rate designed to ensure minimum tax is paid on low tax income and under taxed payments.

The Exposure Draft legislation does not make any reference to whether top up tax that an entity may pay in a particular jurisdiction as a result of the adoption of global minimum tax in that jurisdiction under a OECD Pillar Two Framework would count towards determining whether or not a country is a low corporate tax jurisdiction for the purposes of the rules.

It is submitted that any top up tax paid in a jurisdiction as a result of the adoption of the OECD Pillar Two framework be included in determining whether or not a country is in a low corporate tax jurisdiction for the purpose of the rules.

Royalty withholding tax

Royalties paid from Australia to Switzerland for the use of intangible assets are subject to Australian royalty withholding tax. When determining whether a country is in a low corporate tax jurisdiction, the Exposure Draft legislation does not refer to or include any Australian royalty withholding tax that has effectively been borne by the recipient of the payment. This coupled with the non-availability of a foreign tax credit in Switzerland for the royalty withholding paid in Australia and then a denial of a tax deduction for payments for intangible assets (if Switzerland was considered a low corporate income tax jurisdiction) results in triple taxation of the income derived by the recipient of the payment for the intangible asset.

Given the above, we submit that any royalty withholding tax paid in Australia by the payer of the royalty and in respect of indirect arrangements any subsequent withholding tax paid, and effectively borne and not recovered or credited by the recipient of the royalty be included in determining whether a country is considered to be in a low corporate income tax jurisdiction.

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Subject to tax rules

Pillar Two rules also include a "Subject To Tax Rule" (STTR) which permits source jurisdictions to withhold tax on certain types of related party payments (such as royalties) when such payments are not subjected to a minimum tax rate. The STTR specifically targets risks to source jurisdictions posed by base erosion and profit shifting structures relating to intragroup payments which take advantage of low nominal rates of taxation in the recipient's jurisdiction.

Given there is no specific start date announced for this measure, we submit that the Government deter the commencement date of the Exposure Draft legislation until Pillar Two reforms are finalised before adopting any specific reforms to the taxation of payments for intangible assets, as these reforms may not turn out to be necessary following the implementation of Pillar Two in Australia.

The Exposure Draft legislation provides that the measures apply to payments made on or after 1 July 2023. We acknowledge that many countries are likely not to have adopted the OECD's Pillar Two framework by 1 July 2023. Given this timing mismatch and considering the comments made above, the introduction of these measures would be out of step with both Australia's and the rest of the world's adoption of the OECD Pillar Two framework, noting for example that Switzerland have publicly stated that they intend to adopt the Pillar Two framework from 1 January 2024, subject to a constitutional vote taking place later this year.

Incidental use of intangible assets in marketing and promoting tangible goods and/or in connection to a provision of a service should not be caught

There is significant uncertainty in respect of the potential application of the Exposure Draft legislation due to the broad manner the legislation has been drafted and the lack of clarity the draft Explanatory Materials provide on the scope of the exception in section 26-110(7) for rights / interests in tangible assets for genuine distribution arrangements that may give the Australian entity incidental rights to use intangible assets as well as incidental use of an intangible connected to a service offering.

The Exposure Draft explanatory materials consider the concept of mischaracterisation stating that *"These amendments apply where a contract provides that a payment is made for other things, such as services and tangible goods, and the arrangement also results in the SGE or another entity exploiting, or acquiring a right to exploit, an intangible asset, even at no cost."* The example provided at paragraph 1.31 further demonstrates how wide-ranging the application can be for a distribution arrangement as even the provision of access to a server containing "valuable" confidential information that the Australian entity may use in its role as a distributor is a relevant 'arrangement' on the basis that it would be common understanding between the parties to make such information available.

In contrast, the draft Explanatory Materials only provide limited guidance on when the rules do not apply pursuant to subsection 26-110(7). There is an acknowledgement at paragraph 1.47 that the exception in subsection 26-110(7) was included as *"it is not intended for this anti-avoidance rule to inappropriately apply to genuine supply and distribution arrangements between associates, where there is no tax avoidance behaviour."* However, it is difficult to ascertain precisely what will constitute 'inappropriate' application of the rules when the only example given is the trademark printed on finished good and marketed and sold by a SGE to customers.

In most industries, the distribution of a tangible asset produced by a multinational group involves not only the use of the group's trademark but other intangible assets either embedded in the product itself (which may be protected by patents) or used incidentally by the Australian entity to effectively perform its role as distributor of the asset. For example, access may be required to technical information to address regulatory and safety requirements to allow for the distribution of the product in Australia and / or marketing material or intel to distribute the product in accordance with consistent global methodologies / strategies. We further note that it is common for third parties to structure their arrangements in many industries on a similar basis, i.e., without the need for a bifurcation of a payment for a purchase of goods in similar instances.

Given the rules are sufficiently broad to apply when there is only a common understanding to provide information, we submit that it is critical that that the scope of the exception in subsection 26-110(7) is further clarified to reflect the stated intention for genuine supply and distribution arrangements between associates to not apply and that this includes all incidental uses of intangible assets as a result of making a payment for a tangible asset.

That is, we respectfully disagree with any proposal to separate "embedded royalties" from commercial transactions that do not involve as the main purpose of the transaction as the transfer of rights to use intellectual property in Australia. Indeed, many items sold through an ordinary distribution function are valuable in part due to their intangible value and/or their effective and legally compliant distribution requires some intangible use. Hence further clarity should be if there is no need to unbundle or disaggregate any "embedded royalty" element of a good or a service whereby there is only incidental use and in fact it may and not even be possible to do so.

Finally, we note that concerns related to mischaracterisation were raised in a narrower context by the ATO in Taxpayer Alert 2018/2: *Mischaracterisation of activities or payments in connection with intangible assets*. The Taxpayer Alert states its concerns as including "*whether intangible assets have been appropriately recognised for Australian tax purposes*". However, the Taxpayer Alert also states "*This Taxpayer Alert… does not apply to international arrangements which involve an incidental use of an intangible asset… Whether a use is incidental in this sense will depend on an analysis of the true relationship and activities of the parties*".