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A Hammer in a World of Nails: Australia's New Anti-Avoidance Measure Targeting Payments for Intangibles

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INTRODUCTION

Australia continues to bolster its reputation as a leader in novel approaches to taxing multinational enterprises (''MNEs''). Building on, among other things, its 2015 multinational anti-avoidance law, 2017 diverted profits tax, and 2019 anti-hybrid rules, as part of Australia's 2022–23 Budget, the Australian Government announced a new anti-avoidance measure (the ''New Anti-Avoidance Measure'') to prevent large MNEs from claiming tax deductions for payments relating to intangibles ''connected with low corporate tax jurisdictions.'' On March 31 of this year, the Australian Government released draft legislation and an Explanatory Memorandum[1] with respect to the New Anti-Avoidance Measure.

The New Anti-Avoidance Measure is proposed to be effective with respect to payments made or credited, or liabilities incurred, on or after July 1, 2023.[2] There is an open question as to whether this measure is intended to operate outside of Australia's bilateral income tax treaties. The persons by whom payments, etc., are made are likely to be Australian subsidiaries of MNEs (e.g., distributors). The legislation is still in draft form and was subject to a public consultation that ended on April 28, 2023. To be implemented, it must be passed by the House of Representatives (lower house) and the Senate (upper house) of the Australian Parliament. We expect the Parliament to act on the measure sometime in June 2023. Even if it is not passed by July 1, 2023, there is still a risk the law will be retrospective to July 1.

Broadly, the New Anti-Avoidance Measure would deny Australian deductions for intercompany payments relating to intangible assets if an ''associate'' (defined below) recognizes income from the intangible assets in a jurisdiction with a corporate income tax rate of less than 15%. The Explanatory Memorandum explains the policy rationale of the New Anti-Avoidance Measure as being based on two grounds. The first reflects a familiar refrain: intangible assets are ''readily mobile'' and can easily be moved to low tax jurisdictions with a view to reducing tax in Australia without resulting in a similar amount of tax in the intangible asset jurisdiction.[3] The second has a more Australian flavor: taxpayers are ''mischaracteris[ing]'' arrangements that involve the exploitation of intangible assets so that they can avoid Australian royalty withholding tax.[4]

It is curious that this measure is being proposed amidst the implementation of Pillar Two, which intro-

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[1] Formally, ''Treasury Laws Amendment (Measures for Consultation) Bill 2023: Deductions for Payments Relating to Intangible Assets Connected with Low Corporate Tax Jurisdictions — Exposure Draft Explanatory Materials.''

[2] Explanatory Memorandum ¶ 1.19.

[3] Explanatory Memorandum ¶ 1.7.

[4] Explanatory Memorandum ¶¶ 1.11 – 1.15.

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duces a 15% global minimum tax. Once implemented, Pillar Two would seem to eliminate concerns about companies structuring arrangements so that income is recognized in low-tax jurisdictions.[5] Additionally, Australia has pre-existing anti-avoidance laws that could presumably capture any mischief relating to the mischaracterization of transactions involving intangible assets.

In this column, we walk through the mechanics of the New Anti-Avoidance Measure and discuss the New Anti-Avoidance Measure's implications.

NEW ANTI-AVOIDANCE MEASURE: OVERVIEW

The Operative Rule

The Australian Government proposes to add to *Income Tax Assessment Act 1997* (''ITAA 1997'') new Section 26-110, ''Payments etc. that significant global entities make to associates in relation to exploiting intangible assets connected with low corporate tax jurisdictions.'' Under new Section 26-110, a significant global entity (''SGE'') cannot deduct a payment to an associate that is attributable to a right to exploit an intangible asset if, as a result of the arrangement under which the SGE makes the payment, or a related arrangement, the SGE or an associate (i) acquires the intangible asset, (ii) acquires a right to exploit the intangible asset, or (iii) exploits the intangible asset, and (iv) entering into the arrangement or the related arrangement or (i) – (iii) above results in the recipient of the payment or another associate deriving income in a low corporate tax jurisdiction that stems directly or indirectly from exploiting the intangible asset, or from a related intangible asset.[6] It does not matter whether the SGE makes the payment to the recipient directly or indirectly or where the recipient is located.[7]

In short, if an SGE makes a payment that is attributable to a right to exploit intangible assets, the SGE or an associate acquires or exploits the intangible assets, and an associate of the SGE derives income in a low corporation tax jurisdiction that stems directly or indirectly from exploiting the intangible assets or related intangible assets, then the SGE cannot deduct the payment.

We address the key terms in the operative rule below.

SGE and Associate

Generally speaking, an SGE is (i) an Australian company that has annual global income of AUD 1 billion or more or (ii) an Australian member of a group of companies that are consolidated for accounting purposes whose parent has annual global income of AUD 1 billion or more.[8] An ''associate'' includes an entity within the same accounting consolidated group.[9] Although the term, ''affiliate,'' connotes a similar relationship as associate, we use the term, ''associate,'' throughout this column, in keeping with the language of the proposed legislation.

Arrangement

Section 26-110 uses the Australian term of art, ''arrangement,'' which is defined in subsection 995-1(1) of ITAA 1997. In keeping with this definition, the Explanatory Memorandum notes that an ''arrangement'' is not just an arrangement in its ordinary sense ''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.''[10]

The Explanatory Memorandum explains the reference to a ''related'' arrangement in the proposed statutory language by way of a brief illustration. Although the scope of the term, ''related,'' is unclear at this stage, we would expect there to be a direct or indirect connection between the primary arrangement and the related arrangement.

In the illustration, an Australian entity functions as a distributor for an associate in a low corporate tax jurisdiction. The distribution agreement is silent on intangible assets, but there is a ''common understanding'' that the associate will make available ''access to a server that contains valuable confidential information that the Australian entity may use in its role as a distributor.''[11] Although the Explanatory Memorandum does not elaborate on the illustration, the likely consequence is that a portion of the consideration that the distributor pays the associate is recharacterized as

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[5] The New Anti-Avoidance Measure bears some similarity to the ''subject to tax rule,'' an Inclusive Framework, anti-base erosion measure that has received comparatively less attention than the other elements of Pillar Two. The subject to tax rule is framed as a treaty-based measure, however, and not as a standalone, domestic anti-avoidance rule. *See, e.g., Tax Challenges Arising from Digitalisation — Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, Chapter 9, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (2020) https://doi.org/10.1787/abb4c3d1-en.

[6] New Section 26-110(2).

[7] New Section 26-110(3).

[8] ITAA 1997 Subdivision 960-U.

[9] *See* Income Tax Assessment Act 1936 (''ITAA 1936'') Section 318; Explanatory Memorandum ¶ 1.36.

[10] Explanatory Memorandum ¶ 1.28.

[11] Explanatory Memorandum ¶ 1.31.

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consideration that is within the scope of the New Anti-Avoidance Measure. There is a practical question as to how this consideration is then to be apportioned, but the Explanatory Memorandum does not provide guidance in that regard.

The proper characterization of roles and functions is typically a transfer pricing question. For example, in some intercompany distribution arrangements, the principal appoints an associate to perform a discrete distribution and selling function. The principal provides the associate with the assets the principal believes the distributor requires to perform this function (which may not need to include any intangible component).

Moreover, in many intercompany distribution arrangements, the distributor is not really paying the principal in the first place; rather, the distributor is agreeing to perform a distribution function for the principal in exchange for receiving a portion of the proceeds from the products or services the distributor sells. As noted above, the principal typically provides the distributor with the assets it requires to perform the distribution function, and the level of assistance the principal provides factors into the distributor's compensation. However, there appears to be a proposition implicit in the New Anti-Avoidance Measure that a distributor is an extension of the entrepreneurial function of the principal and should be taken to be exploiting the intangibles or ''stepping into the shoes'' of the principal. This position is likely to generate much interest from the international tax community.

Payment

A ''payment'' includes ''incurring a liability'' or ''crediting an amount.''[12] Therefore, the SGE does not need to make an actual payment to trigger the application of Section 26-110; the SGE appears to be able to accrue an amount that is due and owing as a matter of commercial law to an associate, or to net an amount that the SGE would otherwise owe against an amount that the relevant associate owes to the SGE.

Intangible Asset

Section 26-110 construes the term, ''intangible asset,'' broadly to include both the ordinary meaning of that term as well as anything, the use or supply of which could fall within the domestic law understanding of a royalty, along with any right in respect of an intangible asset or interest in an intangible asset.[13] The Explanatory Memorandum elaborates by noting, for the avoidance of doubt, that intangible assets include software licenses, access to customer databases, algorithms, as well as intellectual property, copyrights, trademarks, and patents.[14] Section 26-110(5)(c) also empowers the Australian Government to issue regulations to modify — e.g., expand — the definition of intangible assets.

Notwithstanding the broad construction above, intangible assets do not include rights or interests in tangible assets or land or financial arrangements.[15]

We use the term, ''intangible asset,'' throughout this column, as opposed to, e.g., ''intangibles,'' ''intangible property,'' or ''intellectual property,'' in keeping with the language of the proposed legislation.

Exploit

Section 26-110 construes the term, ''exploit,'' in a similarly broad manner to mean using, marketing, selling, distributing, supplying, or ''doing anything else in respect of'' an intangible asset.[16] The Explanatory Memorandum provides a few important examples of the types of activities the Australian Government intends to treat as exploiting intangible assets, including (i) issuing a license key or other piece of information that allows access to software or a database; (ii) accessing information on a database; and (iii) ''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, such as a software license, is distributed directly from the offshore associate to the customer.''[17]

The Australian Government's decision to include examples along the lines above is telling, as it signals that the Australian Government is positioning high technology transactions very broadly, in a manner that is consistent with the Australian Taxation Office's (''ATO'')'s approach in Draft Taxation Ruling (''TR'') 2021/D4 and will likely be viewed by industry as an expansion of traditional concepts. As we discuss below, the Australian Government's view of what constitutes exploiting an intangible asset, coupled with TR 2021/D4, makes it more likely that arrangements that MNEs consider to involve the provision of services or the sale of tangible property will nevertheless fall within the New Anti-Avoidance Measure provisions regarding the ''exploitation'' of intangible assets.

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[12] New Section 26-110(4); Explanatory Memorandum ¶ 1.25.

[13] New Section 26-110(5); Explanatory Memorandum ¶¶ 1.42–43.

[14] Explanatory Memorandum ¶ 1.44.

[15] New Section 26-110(7); Explanatory Memorandum ¶ 1.45.

[16] New Section 26-110(9); Explanatory Memorandum ¶ 1.50.

[17] Explanatory Memorandum ¶ 1.52.

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Directly or Indirectly

Under the proposed statutory language and the Explanatory Memorandum, the connection between income from exploiting intangibles and the payment by the Australian company can be extremely tenuous.[18] Oversimplifying, once there is a payment by an Australian company to an associate, directly or indirectly, and that payment is attributable to a right to exploit one or more intangible assets, if the Australian company or an associate acquires intangible assets or exploits intangible assets, and either the acquisition or exploitation of the intangible assets or the payment arrangement ''results'' in an associate deriving income in a low corporate tax jurisdiction from directly or indirectly exploiting the relevant intangible assets, the New Anti-Avoidance Measure applies to deny the Australian company's deduction with respect to the initial payment.

The limits of a regime along the lines above could raise interesting questions. If a low-tax associate licenses intangible assets to a high-tax associate, and the high-tax associate sublicenses the intangible assets to an Australian associate, the arrangement in question ostensibly satisfies the key conditions of the regime. What if, instead, a high-tax associate licenses intangible assets to an Australian associate, and the Australian associate uses the intangible assets to develop a SaaS solution that it sells to another company with a lower tax rate due to a preferential regime? If the company with the preferential tax rate derives income from selling the solution, is there direct or indirect exploitation of the relevant intangible assets? The Explanatory Memorandum does not address this or a myriad of other potential scenarios to which the regime could conceivably apply.

Low Corporate Tax Jurisdiction

As the operative rule makes clear, the key question is whether an associate of the SGE derives income in a low corporate tax jurisdiction from exploiting the intangible assets in respect of which the payment, accrual, or offset is made.[19] Under the proposed statutory language, as a starting point, a foreign country is a low corporate tax jurisdiction if the foreign country has a corporate income tax rate, taking into account only national level corporate tax, that is (i) less than 15%, or (ii) zero, or (iii) if the Australian Government determines that the country's income tax laws ''provide for a preferential patent box regime without sufficient economic substance.''[20] With respect to (iii), the statutory language and the Explanatory Memorandum indicate that findings of the OECD's Forum on Harmful Tax Practices may influence the Australian Government's treatment of a preferential patent box regime.[21]

A foreign country's corporate income tax rate is determined without regard to deductions, tax credits, losses, or treaty benefits.[22] Where the corporate income tax rate depends on the amount of income a taxpayer has, the highest rate is used, but where no income tax is imposed on a particular amount of income, the rate on ''that amount'' is treated as zero, and the lowest rate is used if there are different rates of income tax for ''different types of income.''[23]

In its current formulation, the definition of a low corporate tax jurisdiction is unclear. On the one hand, it appears that the national statutory rate controls, without regard to deductions (barring any action in relation to a ''preferential patent box regime''). Nevertheless, if an amount of income is not subject to tax, it appears that the rate with respect to that income, and not the statutory rate, controls for purposes of the test, regardless of whether the statutory rate is equal to or greater than 15%. Moreover, if there are different rates for different income types, then the lowest rate appears to be used as the rate for the entire regime. It is not clear whether the entity that receives the income must be eligible for the lower rate(s), although that seems to be a logical inference.

One immediate question is whether the United States could be considered a low corporate tax jurisdiction. It is difficult to envision common scenarios in which U.S. associates of Australian companies recognize intangibles-related income that is not subject to U.S. federal income tax, other than by way of deductions, credits, or losses.

U.S. associates of Australian companies do, however, regularly derive income that is subject to a lower rate of corporate income tax under the foreign derived intangible income (''FDII'') regime. Under the primary definition of a low corporate tax jurisdiction, FDII would seem not to cause the United States to be a low corporate tax jurisdiction because the FDII regime achieves its tax rate through a deduction. Similarly, although FDII applies to specific types of income, it does not impose a different rate of income tax on that income — again, because FDII operates by way of a deduction. Nevertheless, it is conceivable

[18] Explanatory Memorandum ¶¶ 1.33–34.

[19] Explanatory Memorandum ¶ 1.53.

[20] New Section 960-258(1), (3); Explanatory Memorandum ¶ 1.55.

[21] New Section 960-258(4); Explanatory Memorandum ¶ 1.64.

[22] New Section 960-258(2)(a).

[23] New Section 960-258(c)–(e).

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that the Australian Government would treat the United States as a low corporate tax jurisdiction on the grounds that FDII represents a ''preferential patent box regime without sufficient economic substance,'' since a U.S. company can derive benefits under FDII without regard to the people functions located in the United States (although, as a matter of fact, the United States typically has sufficient people substance).

It is worth observing that the January 2023 OECD Report on Harmful Tax Practices notes that FDII is ''[i]n the process of being eliminated.''[24] This comment suggests that FDII might well be treated as a harmful tax regime if it continues to remain in place (absent congressional action to eliminate it), and the persistence of FDII might allow the Australian Government to treat the United States as a low corporate tax jurisdiction. Although state tax might cause the combined federal and state tax rate on FDII to exceed 15%, as indicated above, the Explanatory Memorandum explicitly states that ''[o]nly national level corporate tax is relevant for determining whether a foreign country is a low corporate tax jurisdiction.''[25]

The treatment of jurisdictions like Ireland and Singapore seems clearer. Ireland has a statutory rate of 12.5% and therefore appears to satisfy the main test (i.e., a corporate income tax rate of less than 15%). At the same time, Ireland is likely to introduce a qualified domestic minimum top-up tax (''QDMTT'') as part of the EU implementation of Pillar Two, which would increase the rate to 15% for Irish members of accounting consolidated groups with at least EUR 750M revenues — a threshold that seems to align with the SGE threshold in the New Anti-Avoidance Measure.[26] There is a question of whether or not a QDMTT would prevent a jurisdiction from being a low corporate tax jurisdiction. Notwithstanding the introduction of a QDMTT, the jurisdiction's statutory corporate tax rate would not have changed, and the QDMTT might not apply in every case.

Although Singapore has a 17% headline rate, it currently offers lower incentive rates in respect of certain income through preferential regimes. It also does not tax certain types of income, such as capital gains. Based on the proposed statutory language, it is conceivable that a Singaporean associate that does not obtain any beneficial tax rate could also be treated as deriving income in a low corporate tax jurisdiction simply because Singapore offers certain low tax rates (or no tax in some circumstances). As noted above, that does not seem to be a reasonable construction of the statutory language. We also note that, like Ireland, Singapore is considering introducing a QDMTT.

Mischaracterization

As indicated above, a common theme in the Explanatory Memorandum is that taxpayers are mischaracterizing arrangements to disguise consideration for intangible assets as something else. This theme likely reflects the Australian Government's, and the ATO's, concern that intangible assets generally, and marketing intangibles in particular, are susceptible to mischaracterization and are also underrepresented in the transfer pricing positions of Australian subsidiaries of MNEs.

Specifically, the Explanatory Memorandum expresses concerns about situations ''where a contract provides that a payment is made for other things, such as services or 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.''[27] The proposed remedy for mischaracterizing arrangements is twofold. The Explanatory Memorandum proposes to deny a deduction for the portion of the payment that is attributable to intangible assets and to impose a ''shortfall penalty'' on taxpayers that seek to avoid tax, ''including withholding tax.''[28]

EXAMPLE

The Explanatory Memorandum contains a single example, a diagram of which we set forth below.

[24] Harmful Tax Practices — Peer Review Results at 8, 17, Harmful tax practices: Consolidated peer review results of preferential tax regimes (BEPS Action 5) (oecd.org) (January 2023).

[25] Explanatory Memorandum ¶ 1.55.

[26] *See, e.g.,* Pillar Two Implementation, Feedback Statement at 7, Tax Division, Irish Department of Finance (March 2023).

[27] Explanatory Memorandum ¶ 1.37.

[28] Explanatory Memorandum ¶¶ 1.38–39.

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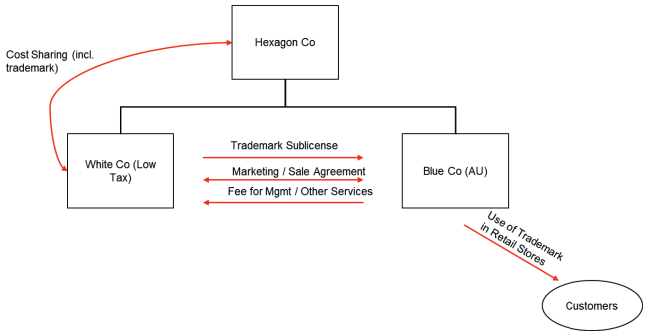

We summarize the example as follows. The Hexagon Co group is in the business of manufacturing and selling clothing and shoes. White Co, Hexagon Co, and Blue Co are all associates. White Co is in a low corporate tax jurisdiction, and Blue Co is in Australia. As the illustration above indicates, Hexagon Co and White Co are participants in a cost sharing arrangement that includes a trademark. White Co engages Blue Co to market and sell Hexagon group clothing and shoes — presumably in Australia, but the example does not specify. White Co sublicenses the Hexagon Co trademark to Blue Co for no consideration. Blue Co pays White Co a fee for management and other services. Blue Co exploits the trademark by using the mark to brand its stores and marketing material.

The example concludes that the New Anti-Avoidance Measure applies because Blue Co acquires the right to use the trademark and exploits the sublicense, and White Co derives income in the form of the management/service fees from Blue Co by exploiting the license it holds pursuant to the cost sharing arrangement in its low tax jurisdiction.[29] Therefore, to the extent the management/service fees are attributable to the trademark/sub-license, Blue Co's deduction for the payment to White Co is denied.

The example stands in contrast to the statement in the Explanatory Memorandum that the New Anti-Avoidance Measure is "not intended . . . to inappropriately apply to genuine supply and distribution arrangements between associates, where there is no tax avoidance behaviour."[30] The Explanatory Memorandum continues: "For example, trademarks printed on finished goods that are marketed and sold by an SGE to customers, without payments to an associate being mischaracterised or being effectively for the use of that trademark in the SGE's business beyond the mere marketing and selling of those finished goods, would be unlikely to attract the operation of this anti-avoidance rule."[31]

Although unclear from the face of the Explanatory Memorandum itself, the distinction between "genuine supply and distribution arrangements" and the mischaracterization on which the example focuses may lie in the fact that the example strays from a typical intercompany distribution arrangement. As noted above, in a common intercompany distribution arrangement, the distributor does not pay any fee to the principal. Instead, the principal effectively remunerates the distributor, by allowing the distributor to retain a portion of the sales proceeds and, more often than not, paying the distributor a market support fee to the extent the distributor's sales fail to materialize sufficiently. In this type of distribution arrangement, the distributor does what the Explanatory Memorandum views as characteristic of a genuine supply and distribution arrangement and receives a royalty-free, non-exclusive, revocable trademark license that allows the distributor to market and sell trademarked products in the distributor's territory. On one view, the example's facts more closely resemble those of a franchise arrangement, in which the franchisee pays a franchise fee for both services from the franchisor and intangible rights that the franchisor owns or licenses, as opposed to a distribution arrangement. That said, it is doubtful that many intercompany franchise arrangements reflect attempts to disguise the fact that some portion of the franchise fee is for intangible assets.

The issues raised in the New Anti-Avoidance Measure are not particularly new in an Australian context, but it will be the first time there is targeted legislation along the lines of the measure. The ATO has been holding a similar view for some time. For example, the ATO issued a Taxpayer Alert in 2018[32] out of concern that intangible assets were not being appropriately recognized for Australian tax purposes. The ATO observed that arrangements that allocate all consideration to tangible goods and/or services, arrangements that allocate no consideration to intangible assets, and arrangements that view intangible assets collectively, or conceal intangible assets, may be more likely to result in a mischaracterization. In that Taxpayer Alert, the ATO noted that these types of arrangements typically display most, if not all, of the following features: intangible assets are developed, maintained, protected, or owned by an entity located in a foreign ju-

[29] We find it puzzling that the example treats Blue Co as acquiring intangible assets in the form of the right use the Hexagon trademark and a sublicense, since the sublicense is the legal instrument that grants Blue Co its trademark rights. We do not attempt to resolve this puzzle in this column.

[30] Explanatory Memorandum ¶ 1.47.

[31] Explanatory Memorandum ¶ 1.47.

[32] *See* Taxpayer Alert TA 2018/2: Mischaracterisation of activities or payments in connection with intangible assets (https://www.ato.gov.au/law/view/document?DocID=TPA/TA20182/NAT/ATO/00001).

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risdiction (an ''IP entity''); the Australian entity enters into an arrangement to undertake an activity or a combination of activities; the Australian entity requires the use of the relevant intangible assets in order to undertake these activities; the Australian entity purchases goods and/or services from an IP entity or a foreign associate of an IP entity in order to undertake these activities; and the Australian entity agrees to pay an amount, or a series of amounts, to a foreign entity which the Australian entity does not recognize or treat as wholly or partly being for the use of an IP entity's intangible assets. The ATO notes that it was concerned that arrangements of this type may be entered into or carried out for the dominant or principal purpose of obtaining a tax benefit. The ATO notes that these types of arrangements may attract the operation of the general anti-avoidance rules in Part IVA of ITAA 1936 and/or the application of the diverted profits tax.

In a similar vein to the New Anti-Avoidance Measure, the Taxpayer Alert does not apply to international arrangements which involve an incidental use of an intangible asset. For example, the ATO notes that the Taxpayer Alert does not apply to resellers of finished tangible goods where the activity of reselling the goods involves an incidental use of a brand name that appears on the goods and related packaging. The ATO considers that whether a use is incidental in this sense will depend on an analysis of the true relationship and activities of the parties. One could argue that this criterion alludes to a transfer pricing analysis and delineating the actual activities and functions of each entity. This allusion then naturally takes MNEs down a familiar path of having to justify the characterization of their distributor and establish whether it embodies more entrepreneurial functions or is merely a distributor with more limited functions.

There would certainly be a mischief if an MNE were to mischaracterize arrangements to avoid tax, and we agree that there should be integrity measures to address those circumstances. However, the rules should be appropriately measured and should not inadvertently capture legitimate distribution arrangements where no use of intangibles is actually required to perform the distribution function.

IMPLICATIONS

Increase in Risk of Royalty Characterization

The New Anti-Avoidance Measure is further evidence of the Australian Government's belief that taxpayers are trying to avoid withholding tax by treating arrangements involving consideration for the use of intangible assets as services or tangible property arrangements. Although, by its terms, the New Anti-Avoidance Measure operates to deny deductions in respect of payments that are attributable to a right or permission to exploit intangible assets, and therefore can apply to payments to acquire intangible assets that ostensibly do not constitute royalties for Australian tax purposes, the Explanatory Memorandum nevertheless notes that the measure ''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 deductions for payments made by the SGE to an associate that are attributable to those or related intangible assets are claimed in Australia.''[33] Taken together with the broad manner in which the proposed legislation and the Explanatory Memorandum construe the concept of exploiting intangible assets, it seems reasonable to interpret the New Anti-Avoidance Measure as a statement of the Australian Government's position regarding the range of payments that may constitute royalties that are subject to Australian withholding tax. The New Anti-Avoidance Measure therefore appears to represent an outgrowth of TR 2021/D4 and, accordingly, appears not to require what industry might view as an actual use of copyrights (or other intangible assets) for arrangements to be captured.

As readers may recall, the ATO released TR 2021/D4, which remains in draft, to address the modern form of software distribution and delivery. TR 2021/D4 contains two examples of interest. In Example 4, an Australian company distributes software by entering into end-user license agreements with Australian customers. When a customer places an order, the Australian company notifies the software provider, and the provider generates a key that allows the customer to download the software from a website and server that the Australian company does not own or control. The license limits the customer's use of the software and specifically does not permit the customer to modify or make multiple copies of the software. The ATO concludes that payments from the Australian company to the software provider constitute royalties because the Australian company is sublicensing software and specifying the terms of use. In Example 5, an Australian company enters into the terms of use with respect to a SaaS offering with its customers when it sells them subscriptions to the offering. The ATO concludes that the Australian company's distributor fee constitutes a royalty to the SaaS provider because the terms of use include a non-exclusive license to access the software, and the Australian com-

[33] Explanatory Memorandum ¶ 1.17.

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pany acquires the right to grant this license from the SaaS provider.

TR 2021/D4 does not acknowledge or address the fact that an end user license is typically not in fact a grant of rights but is instead a defensive measure that prevents the user from doing things that the supplier does not want the user to do — e.g., reverse engineer the software. Therefore, a distributor that grants an end user license is typically not exercising any rights in respect of intangible assets; rather, the distributor is entering into a negative covenant with the user. Similarly, the fact that a distributor may enter into an end-user license/terms of use with a user does not cause the distributor to be transformed from a commercial intermediary that facilitates the distribution of a software/digital solution into a licensee that exploits intangible assets and therefore should be disregarded for purposes of characterizing the arrangement between the distributor and the supplier pursuant to paragraph 14.4 of the Commentary on Article 12 of the OECD Model Tax Convention.[34] Rather, TR 2021/D4 considers that the distributor is paying for the right to ''stand in the shoes'' of the copyright owner. Again, the difference in views appears to center on the proper characterization of the distribution function itself.

The New Anti-Avoidance Measure and TR 2021/D4 therefore indicate that the ATO is likely to assert that software distribution arrangements, SaaS reseller structures, and even tangible property distribution models have a royalty component. In addition, the New Anti-Avoidance Measure would expressly empower the ATO to deny deductions. Accordingly, MNEs should carefully review arrangements they believe qualify as transactions involving services or tangible property to see whether there are grounds for the ATO to recharacterize those arrangements as involving the exploitation of intangible assets. Additionally, the New Anti-Avoidance Measure may cause MNEs to focus on ensuring that there is strong support, including in the form of economic analysis, to substantiate the apportionment of a payment, or possibly even dissect the payment in the agreement itself, to identify an actual royalty component. The value of using a trademark or brand in the context of a sales and distribution function is likely to be an area of contention, as the approach to this question is uncharted waters in the international tax arena, given the existing OECD Commentary view that the incidental use of brands/trademarks in the course of distribution functions is generally disregarded.[35]

U.S. Foreign Tax Credit Considerations

As we indicate above, the New Anti-Avoidance Measure appears to reflect the Australian Government's belief that more payments are attributable to the right to exploit intangible assets than taxpayers may think. Accordingly, taxpayers may find themselves with a greater amount of Australian royalty withholding tax than they may expect. One immediate question is whether this additional withholding tax will be creditable for U.S. foreign tax credit purposes. We focus on two elements of the foreign tax credit regulations' net gain requirement in Treas. Reg. §1.901-2(b) below.

As readers will recall, the attribution requirement in the final U.S. foreign tax credit regulations provides that foreign tax law generally determines the character of a payment for foreign tax credit purposes. Therefore, to the extent Australian tax law treats a payment as a royalty, withholding tax on that royalty should be tested under the attribution requirement for royalties in Treas. Reg. §1.901-2(b)(5)(i)(B)(*2*). Therefore, generally speaking, whether Australian withholding tax that the ATO asserts pursuant to the logic of TR 2021/D4 or the New Anti-Avoidance Measure satisfies the attribution requirement should turn on whether Australia sources royalties based on the place of use of, or the right to use, intangible assets, as determined under reasonable principles.[36]

Where a U.S. associate of an Australian company receives the payment and is the person who is legally liable for the tax as a matter of Australian law, however, the analysis becomes a bit more complex. In that case, the treaty coordination rule in Treas. Reg. §1.901-2(a)(1)(iii) could apply to bypass the attribu-

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[34] *See* OECD Model Tax Convention, Commentary, Art. 12 ¶ 14.4 (''Arrangements between a software copyright holder and a distribution intermediary frequently will grant to the distribution intermediary the right to distribute copies of the program without the right to reproduce that program. In these transactions, the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business profits in accordance with Article 7. This would be the case regardless of whether the copies being distributed are delivered on tangible media or are distributed electronically (without the distributor having the right to reproduce the software), or whether the software is subject to minor customisation for the purposes of its installation.'').

[35] *See* OECD Model Tax Convention, Commentary, Art. 12 ¶ 10.1.

[36] *See* Prop. Reg. §1.901-2(b)(5)(i)(B)(*2*).

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tion requirement because there is a bilateral income tax treaty between the United States and Australia that contains a Relief from Double Taxation Article that requires the United States to allow a U.S. citizen or resident ''the appropriate amount of income tax paid to Australia'' as a credit against U.S. tax.[37] If the U.S. associate elects the benefits of the treaty, as the treaty coordination rule requires, there is likely to be a question of whether the Competent Authorities of the United States and Australia agree with the characterization of the payment under the treaty. Absent agreement between the United States and Australia on royalty character, and on the right of Australia to impose tax at source, it is unclear what the result under the treaty coordination rule would be. What does it mean to elect the benefits of the treaty if the Competent Authorities fail to reach agreement on the ''appropriate amount of income tax paid to Australia''? Perhaps the analysis defaults to the net gain requirement, in which case the tax must be tested under the attribution requirement for royalties, as set forth above.[38] If the conclusion under the attribution requirement is favorable, concerns about the application of the treaty coordination rule may be moot.

At a more fundamental level, given that the Australian Government may view the New Anti-Avoidance Measure as sitting outside Australia's tax treaties, there is a question of whether the treaty coordination rule even applies in the first place. The answer ought to be yes. The Relief from Double Taxation Article provides for a U.S. foreign tax credit with respect to Australian income tax, and any withholding tax that arises on payments to which the New Anti-Avoidance Measure applies remains Australian income tax. The thornier question, as outlined above, is whether an irreconcilable difference in opinion between the United States and Australia regarding whether payments are royalties in the first place could preclude the application of the treaty coordination rule.

The foreign tax credit implications of Australian corporate income tax that arises under the New Anti-Avoidance Measure ought to be more straightforward. The New Anti-Avoidance Measure ought to satisfy the cost recovery requirement in Treas. Reg. §1.901-2(b)(4) because the proposed foreign tax credit regulations state that measures that disallow deductions do not prevent foreign taxes from satisfying the cost recovery requirement so long as the disallowance is ''consistent with any principle underlying the disallowances required under the income tax provisions of the Internal Revenue Code, including the principles of limiting base erosion or profit shifting and addressing non-tax public policy concerns similar to those reflected in the Internal Revenue Code.''[39] The Explanatory Memorandum indicates that base erosion concerns motivate the New Anti-Avoidance Measure, at least in part, because the Explanatory Memorandum observes that taxpayers may be structuring arrangements so that income is recognized in low-tax jurisdictions while an Australian company recognizes a deduction against Australian taxable income.[40] Limiting deductions due to base erosion concerns seems to fall squarely within the principles of a number of U.S. Internal Revenue Code provisions, including Section 59A (the BEAT), Section 163(j), and Section 267A. Therefore, Australian corporate income tax that arises under the New Anti-Avoidance measure would seem to satisfy the cost recovery requirement.[41]

CONCLUSION

As the discussion above indicates, the New Anti-Avoidance Measure is very broad and could result in a denial of deductions for a wide array of payments from Australian companies to associates located in common Australian trading partners, particularly if the United States (which presumably would have sufficient economic substance) is brought within the concept of a low corporate tax jurisdiction. At the same time, the measure may have a limited shelf life given the expected implementation of Pillar Two. Although the consultation period ended on April 28, we expect that companies affected will desire further engagement on the measure with the Australian Treasury, including to understand the interaction of the measure with Pillar Two.

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[37] *See* Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Article 22(1)(a).

[38] Even if Australian withholding tax on amounts that are treated as services for U.S. tax purposes is considered a foreign income tax for purposes of Section 901, the income associated with that tax should be sourced under the rules for sourcing services income. In the context of payments to a U.S. associate of an Australian company, this conclusion likely results in U.S. source income, which could curtail a company's foreign tax credit limitation.

[39] Prop. Reg. §1.901-2(b)(4)(i)(F).

[40] *See* Explanatory Memorandum ¶ 1.17.

[41] The New Anti-Avoidance Measure also ought not to conflict with the requirement in Treas. Reg. §1.901-2(b)(5)(ii) that Australian tax law ''provide that any allocation to or from [an Australian resident] of income, gain, deduction, or loss with respect to transactions between such resident and organizations, trades, or businesses owned or controlled directly or indirectly by the same interests (that is, any allocation made pursuant to the foreign country's transfer pricing rules) is determined under arm's length principles.'' The New Anti-Avoidance Measure does not change the allocation of income between Australia and other jurisdictions; rather, the measure disallows deductions with respect to expenses that are properly allocable to Australia.

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