International Bar Association Annual Conference 2024

Recent Developments in International Taxation

Australia

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Introduction

The Australian Federal Government (the 'Government') has proposed or clarified a number of measures in the last 12 months that are consistent with its legislative agenda to increase transparency, increase Australian tax reporting obligations and limit deductibility for payments that are perceived to erode the Australian tax base.

Australia proposes the implementation of a global and domestic minimum tax

On 21 March 2024, the Government released exposure draft legislation to implement key aspects of Pillar Two of the Organisation for Economic Co-operation and Development's (OECDs) base erosion and profit shifting (BEPS) 2.0 global initiative and address the tax challenges arising from the digitalisation of the economy (the 'GloBE Rules'). The proposed changes include a 15 per cent global minimum tax (GMT) for large multinational enterprise (MNE) groups.

The proposed GloBE Rules have two elements: income inclusion rule (IIR) and undertaxed profits rule (UTPR). In summary:

1. from 1 January 2024, the IIR applies a 'top-up' tax to Australian headquartered MNE groups and Australian entities that are subsidiaries of a foreign-headquartered multinational corporation (MNC) located in a country that has not implemented this rule (ie, income is taxed below 15 per cent in another country); and

2. from 1 January 2025, where the IIR does not apply, the UTPR will apply to foreign MNE groups operating in Australia.

In addition to the GMT, the draft legislation imposes a 15 per cent domestic minimum tax (DMT) applying from income years starting on or after 1 January 2024. The DMT applies so that Australia retains taxing rights over undertaxed Australian profits to obtain tax revenue that would otherwise be collected by another country under its GMT rules.

The European Union, Canada, Japan and the United Kingdom, have made similar commitments to implementing a GMT from 2024.

Who will be affected by the proposed measure

The GMT and DMT are set to apply to MNE groups with an annual global revenue of €750m (approximately AU$1.2bn) or more in at least two of the four financial years immediately preceding the testing year (referred to as the 'GloBE Threshold') and will require these MNE groups to pay an effective minimum level of tax on income in each country in which they operate.

Important changes to the Australian thin capitalisation regime have been legislated

Significant changes have been passed by the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Act 2024 (Cth) to Australia's thin capitalisation tax regime, which are set to apply from income years commencing on or after 1 July 2023.

These amendments reflect the Government's commitment to amending Australia's thin capitalisation rules to align with the OECD's recommended approach under Action 4 of the BEPS Action Plan. Specifically, the amendments target BEPS arrangements by addressing the risk of erosion to Australia's tax base arising from excessive debt deductions.

The proposed amendments replace the existing thin capitalisation rules, which indirectly addressed BEPS measures (which focused on an entity's ratio of debt to equity), with new direct earnings-based rules for non-financial entities ('general class investors'). The proposed amendments also establish a new arm's length debt test (ALDT) in the form of an external third-party debt test.

The changes also include a measure of making interest non-deductible where it relates to the funding of non-portfolio foreign equity.

Summary of the change

The Exposure Draft introduces new thin capitalisation earnings-based tests targeted at general class investors that may disallow all or part of the entity's debt deductions for an income year. The following new tests apply to general class investors:

- a fixed ratio test to replace the existing safe harbour test;
- a group ratio test to replace the existing worldwide gearing test; and
- an external third-party debt test to replace the ALDT (this test also applies to financial entities that are not authorised deposit-taking institutions (ADIs)).

General class investors will capture entities previously covered by the existing classes of entities in the current thin capitalisation rules – being 'outward investor (general)', 'inward investment vehicle (general)' and 'inward investor (general)' – but will not capture financial entities or ADIs. This means that general class investors will include:

- Australian entities carrying on business in a foreign country at or through a permanent establishment, or through a controlled entity;
- Australian entities that are controlled by foreign residents; and
- foreign entities with investments in Australia.

Financial entities and ADIs are not general class investors for the purposes of the new rules, and therefore, are not caught and continue to be subject to the existing thin capitalisation tests (with the exception of the ALDT, which is replaced by the external third-party debt test, but these entities will continue to have access to the arm's length capital test). The proposed changes also amend the definition of a financial entity for these purposes by removing from the definition an entity that is not an ADI but is a registered corporation under the Financial Sector (Collection of Data) Act 2001. This means that non-ADI corporations can no longer register under that statute and qualify as a financial entity for the purposes of the thin capitalisation rules.

New penalty for a mischaracterised or undervalued royalty payment

The Government has announced that it will impose a new penalty on significant global entities (SGE) that are found to have mischaracterised or undervalued royalty payments to which royalty withholding tax would otherwise apply. The provision will apply from 1 July 2026. The proposed penalty demonstrates the Australian Taxation Office's (ATO's) continued concerns over the potential existence of royalty payments embedded in the consideration paid for tangible goods or services. This new penalty provision may also be relevant in the context of Draft Taxation Ruling TR 2024/D1, which details the ATO's view on when payments made in respect of a software arrangement will be subject to royalty withholding tax. We discuss TR 2024/D1 at length below.

This new penalty was only recently announced in the Federal Budget 2024/25. As such, there is limited commentary as to the operation of such a provision, the details of which will be significant to SGE. Detail will also need to be issued in relation to how this provision will interact with existing anti-avoidance and transfer pricing provisions.

ATO finalises Practical Guidance 2024/1

Introduction to Practical Guidance 2024/1

The ATO has finalised Practical Compliance Guideline 2024/1 ('PCG 2024/1'), which sets out the ATO's compliance approach to cross-border arrangements involving:

1. the migration of intangible assets, whether or not such a migration has actually occurred; a migration is defined as a restructure or change to the way an entity accesses, holds, uses or even benefits from an intangible asset; and
2. the mischaracterisation and non-recognition of Australian activities connected with intangible assets, picking up arrangements relating to Australian development, enhancement, maintenance, protection and exploitation (DEMPE) activities in connection with intangible assets held offshore (intangible migration arrangements).

PCG 2024/1 introduces two intangible arrangement risk assessment frameworks, as well as 15 examples illustrating factors considered when assessing compliance risks. Prudent taxpayers should engage with the risk assessment framework to determine what 'risk zone' and corresponding 'risk rating' they fall within, with a red risk zone indicating the highest risk of unwanted ATO attention. Note that the definition of intangible assets in the PCG is very broad in ambit and includes property, assets and rights that are not physical or financial assets and are capable of being owned or controlled for use in commercial activities.

Development and public feedback

Before the final version, the PCG was released in draft form as PCG 2021/D4 and PCG 2023/D2. The initial draft was subject to extensive public consultation and feedback. Feedback was that it required taxpayers to produce commercially onerous and impractical evidentiary requirements to obtain a low risk rating. In response, a second draft was issued to remove the direct link between the documentary evidence criteria and a taxpayer's risk rating. However, the onerous evidentiary requirements were maintained in both the second draft and the final PCG 2024/1.

Evidentiary expectations

Evidentiary requirements include the need for contemporaneous documents demonstrating commercial decision-making, evidence of contemporaneous documentation of the substance of DEMPE functions, and evidence identifying the tax and profit outcomes of intangible arrangements.

PCG 2024/1 applies from 17 January 2024 to existing and new arrangements.

ATO publishes draft TR 2024/D1

Summary

TR 2024/D1 is a revised draft ruling by the ATO concerning whether payments in software distribution arrangements may be characterised as royalties, with royalty withholding tax implications. Despite feedback from the legal and technology industries on the earlier draft TR 2021/D4, including concerns that the views expressed in the first draft were a unilateral departure from international norms, there appears to be no substantive change in the ATO's position in the updated draft ruling.

Explanatory scenarios

The ATO's views are now summarised in two indicative scenarios. The scenarios together highlight the ATO's view that:

1. the right of an Australian distributor to make copies of software would constitute the grant of an exclusive right of a copyright holder; and

2. in circumstances where an Australian distributor enters into an agreement with the end-user and that agreement specifies the software that the end-user will obtain, the distributor is responsible for determining the software programs communicated to the user. The right to communicate a copyright work to an Australian end-user is the use of copyright (even where non-exclusive) and also includes the corresponding right to authorise that communication.

Use of copyright

The domestic definition and standard tax treaty definition of royalty provide for a similarly worded definition of the term 'royalties', which means payments or credits, whether periodical or not, and however described or computed, to the extent to which they are made as consideration for the use of, or the right to use, any copyright. The definition begs the further question of what 'use' is, which can only be defined by copyright legislation insofar as intellectual property as a body of law is a creature of statute. In Australian copyright legislation, the 'use' of copyright is the use of a copyright owner's exclusive rights, which would otherwise be an infringement of copyright.

However, the ATO has taken an expansive view in TR 2024/D1 that the 'use' of copyright covers all forms of 'exploitation' of the right or property short of an outright sale of that right. This view exceeds the approach taken by other OECD nations. Indeed, OECD commentary is to the effect that simple distribution arrangements will not commonly be a 'use' of intellectual property.

Apportionment

The draft ruling makes it clear that where no attempt at apportionment is made and a payment for intellectual property is an 'undissected' amount, then the entirety of the payment is likely to be classified as a royalty, given the presumption that the right to use the intellectual property is inseparable from the other aspects of the transaction. It is at least clear that some attempt to apportion the amount should be made in these scenarios by taxpayers, given the quasi-reverse-onus of proof this generates.

The ATO has offered some very limited guidance on this apportionment point, insofar as paragraph [19] allows for apportionment 'to be done on a fair and reasonable basis considering all the relevant facts and circumstances of the particular case'. This shines little light on when intellectual property rights are in fact severable from the rest of the transaction, though it is recommended that taxpayers retain sufficient evidence that the distribution right (or other rights falling outside the definition of royalties) has substantial value independent of the right to use the copyright and other intellectual property for this purpose.

Strengthening the foreign resident capital gains tax regime

The Government recently announced changes to the foreign resident capital gains tax (CGT) regime in the Federal Budget 2024/25 designed to expand its operation and to ensure greater compliance by foreign residents with their CGT obligations in Australia. The proposal seeks to close the gap in the amount of CGT being collected when foreign residents dispose of their indirect interests in Australian land. The amendments will apply to CGT events that occur on the entry into sale contracts on or after 1 July 2025.

Currently, foreign residents are subject to CGT on taxable Australian property (TAP). This is, broadly, direct interests or certain indirect interests in Australian land (eg, shares or units in landholder companies and trusts). Indirect interests in Australian land will be TAP only if the following two tests are satisfied:

1. principal asset test: the market value of the assets held by the company or trust is more than 50 per cent attributable to taxable Australian real property (being Australian real property or mining, quarrying or prospecting rights in respect of Australian minerals, petroleum and quarry materials), measured at the time of the CGT event that is relevant to the disposal of the interests; and

2. non-portfolio interest test: the foreign resident (together with its associates) held ten per cent or more of the interest in the company or the trust either at the time of the CGT event or throughout a 12-month period that began no earlier than 24 months before the time of the CGT event.

First change: amending the point-in-time principal asset test

The proposal is to apply a 365-day testing period to the principal asset test, which essentially means that staggered sell downs of the underlying land assets cannot be undertaken within a 12-month period prior to a disposal by foreign residents of their indirect interests so as to avoid CGT. The longer testing period also means that a single market valuation at a point during the 365-day window may be sufficient to satisfy the principal asset test, even though the market value of taxable Australian real property may subsequently fall.

Second change: broadening the tax base

The budget is proposed to tax foreign residents on direct and indirect sales of assets with 'a close economic connection to Australian land, more in line with the tax treatment that already applies to Australian residents'. This suggests that the concessional CGT treatment that applies to foreign residents could be significantly wound back.

Third change: introducing a notification obligation

The proposed new obligation on foreign residents to notify the ATO of a disposal exceeding $20m in value applies only to disposals of indirect interests in Australian land (shares and units) and does not apply to direct holdings of Australian land. Currently, a purchaser must apply foreign resident capital gains withholding (FRCGW) at the rate of 12.5 per cent to the purchase price, unless the sale is excluded or the vendor provides a declaration (typically in the unit or share sale agreement) stating that the units or shares are not an indirect Australian real property interest and the purchaser does not know or does not have reasonable grounds to believe the vendor is a foreign resident. It appears that the new vendor notification is designed to operate together with the FRCGW regime in order to alert the ATO to high

value transactions that may appropriately be subject to CGT. It will be interesting to see how this is actually enforced by the ATO.

Notably, the Government has already announced (in the Mid-Year Economic and Fiscal Outlook) its intention to amend the law to increase the FRCGW rate to 15 per cent and reduce the purchase price threshold for which FRCGW applies from $750,000 to nil from 1 January 2025.

General anti-avoidance rule (GAAR): *Mylan Australia Holding Pty Ltd v FCT (No 2) [2024] FCA 253*

On 20 March 2024, the Federal Court found in favour of the taxpayer Mylan Australia Holding Pty Ltd (MAHPL), ruling that the Commissioner of Taxation's amended assessments disallowing interest deductions under Australia's general anti-avoidance rules (Part IVA) were excessive in the context of inbound debt funding into Australia.

Background facts

In May 2007, the Mylan Group (headquartered in the United States) negotiated the acquisition of five group companies from a Dutch resident company, Merck Generics Group BV ('Merck Generics'). One of the target companies was the lead generic pharmaceuticals company in Australia at the time, Alphapharm Pty Ltd ('Alphapharm'). The acquisition occurred in October 2007 by way of share purchase, for nearly $7bn in consideration.

Following the receipt of tax advice, the share purchase agreement between the parties was amended to facilitate the acquisition of Alphapharm by a newly incorporated Mylan subsidiary. As such, the Mylan Group incorporated two entities in Australia to facilitate the acquisition:

1. Mylan Australia Pty Ltd (MAPL), to acquire all the shares in Alphapharm; post-acquisition, Alphapharm became a subsidiary of MAPL; and

2. MAHPL (ie, the applicant), being the head of the Australian tax consolidated group (TCG) and the direct parent company of MAPL. As the head of the TCG, this is the company the ATO issued amended assessments against following an audit of the Alphapharm share acquisition by MAPL.

The decision concerned the financing of MAPL's acquisition of the shares in Alphapharm. MAPL funded the acquisition through a mixture of debt and equity financing in a 3:1 ratio, as permitted under the thin capitalisation 'safe harbour' provisions at the time. Debt financing was issued to MAPL by a related Mylan Luxembourg entity in the form of promissory notes (as opposed to a third-party lender). The Commissioner applied Part IVA to MAHPL (ie, as the head of the TCG) to disallow interest deductions on the promissory notes.

At a very high-level, the Commissioner's position was that MAPL obtained a tax benefit in receiving an intra-group loan from its Luxembourg associate. With several counterfactuals in play, the judge introduced a new counterfactual, being that MAPL would have borrowed the equivalent debt on a seven-year term, under a senior credit agreement (SCA) from external third-party lenders, at a floating rate consistent with the rates specified in the SCA.

Tax benefit and dominant purpose test

The Court rejected the Commissioner's primary argument that, if the relevant 'scheme' had not been entered into, MAHPL would not have acquired Alphapharm and thus would not have had the related debt, which resulted in interest deductions claims in Australia. Instead, the Court concluded that the dominant purpose of the scheme was not to obtain an Australian tax benefit, notwithstanding that certain features of the scheme appeared to have a tax motivation (including failing to refinance Australian debt in light of falling interest rates).

Relevantly, and consistent with the Full Federal Court's recent decision in *Minerva Financial Group Pty Ltd v Commissioner of Taxation* ('Minerva'), the Court stressed that an objective analysis of purpose must be carried out in determining whether or not deriving a tax benefit is the most influential purpose of a scheme, taking into account also the commercial and financial consequences of such a scheme.

The decision provided some further guidance on how the courts will consider whether or not taxpayers have discharged their onus to prove that the assessments are excessive under Part IVA litigation. The Court made comments to the effect that the burden of proof resting with taxpayers does not absolve the Commissioner of his/her obligations, as a party to proceedings, under section 37N of the Federal Court of

Australia Act 1976. Consequently, where taxpayers have made submissions as to the facts and the evidence, they say, supports those facts, the Commissioner will not be able to rely on taxpayers' onus to avoid agreeing to, or conceding, any facts in a proceeding in the absence of reasons as to why they do not agree.

Royalties and diverted profits tax case law: ***PepsiCo, Inc v Commissioner of Taxation [2023] FCA 1490***

The PepsiCo decision considered the application of the royalty withholding tax and the diverted profits tax provisions. The proceeds concerned two 'exclusive bottling agreements' (EBAs) between:

1. PepsiCo, Inc ('PepsiCo') and Schweppes Australia Pty Ltd, later acquired by Asahi ('SAPL'); and
2. Stokely-Van Camp, Inc ('SVC') and SAPL.

Under the respective EBAs, PepsiCo and SVC agreed to sell concentrate to SAPL who would then mix the concentrate and distribute the finished product in the Australian market. SAPL was granted a licence over the respective intellectual property in order to do so. While the EBAs were directly between PepsiCo/ SVC and SAPL, the concentrate went via other entities in the PepsiCo group:

1. Concentrate Manufacturing (Singapore) Pty Ltd ('CMSPL') (a Singapore entity and member of the PepsiCo group) would receive flavour keys from PepsiCo or SVC;
2. CMSPL would supply concentrate to PepsiCo Beverage Singapore Ltd ('PBS') (an Australian entity and member of the PepsiCo group); and
3. PBS would then supply the concentrate to SAPL.

The ATO successfully argued that, irrespective of the fact that PepsiCo and SVC were not being paid under the EBAs, there was still a royalty payment, insofar as the payments to PBS were still 'consideration for' the right to use the intellectual property and therefore 'moved' the transaction. PepsiCo and SVC were also found to have derived the payments for the purposes of the royalty withholding tax provisions. This attracted a royalty withholding tax rate of five per cent under the Double Taxation Treaty between Australia and the US. The judge also held that, as an alternative, if it was found that a royalty was not paid, the new diverted tax provisions would have applied having regard to the anti-avoidance matters in subsection 177J(2) of the Income Tax Assessment Act 1936 (Cth). In particular, the Court concluded that one of the principal purposes of each of PepsiCo and SVC carrying out the scheme was to obtain a tax benefit.

The PepsiCo decision is the first to consider the application of the diverted profits tax provisions. However, note that an appeal of the first instance decision was heard in early May 2024 and is currently pending judgment.