The ATO continues its focus on cross-border arrangements involving intangible assets

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In brief

The Australian Taxation Office (ATO) released a new *Taxpayer Alert (TA 2020/1)* on international arrangements involving the development, enhancement, maintenance, protection and exploitation (hereafter referred to as "DEMPE") of intangible assets on 22 January 2020.

Specifically, TA 2020/1 outlines the ATO's concerns in relation to non-arm's length arrangements and schemes connected with the DEMPE of intangible assets. The ATO also illustrates typical features of those arrangements through three examples.

TA 2020/1 is intended to capture arrangements that display a potential misalignment between the contribution of Australian entities to DEMPE functions and the remuneration of those entities. It is also intended to capture arrangements that appear to lack commercial rationale (and/or substance), or not be consistent with the economic interests of the relevant Australian entities.

The potential consequences for taxpayers include:

- application of the transfer pricing rules to deny any transfer pricing benefit (which may include reconstruction of the arrangements);
- application of anti-avoidance rules, including the General Anti-Avoidance Rule ("GAAR") and the Diverted Profits Tax ("DPT"); and
- double taxation in cases of inconsistent interpretations by countries or application of anti-avoidance rules.

While the examples and points of emphasis within TA 2020/1 are consistent with the focus around the alignment of substance and profit as found within the OECD Transfer Pricing Guidelines (which are incorporated in the Australian transfer pricing rules) and across the Australian anti-avoidance provisions, the Alert is another example of the ATO putting taxpayers on notice in relation to specific cross-border arrangements which are a key focus. In addition to TA 2020/1, we understand that the ATO is developing a Practical Compliance Guideline ("PCG") outlining its compliance approach in respect of cross-border arrangements involving intangibles.

As a result, taxpayers with arrangements involving the cross-border development and/or exploitation of intangible assets should conduct a detailed review of their current arrangements to determine if they fall into the circumstances described in the Taxpayer Alert and consider any appropriate action to be taken. The review of such arrangements should consider whether sufficient evidence has been prepared through the annual transfer pricing documentation process to demonstrate the alignment of profits to DEMPE functions across the value chain. This is in addition to consideration of future disclosure requirements in

the Reportable Tax Position Schedule and the International Dealings Schedule ("IDS") that may be required to be lodged with Australian tax returns, as well as Country by Country ("CBC") documentation.

In detail

TA 2020/1 outlines the ATO's concerns in relation to international arrangements that mischaracterise Australian activities connected with the DEMPE of intangible assets.

More specifically, the ATO's concerns relate primarily to the following:

1. whether the activities performed by Australian entities in relation to the DEMPE of intangible assets are appropriately recognised and rewarded with reference to transfer pricing principles; and
2. whether any migration of intangible assets complies with Australian laws, including under transfer pricing rules as well as capital gains tax ("CGT") and depreciation rules.

The ATO also notes that transactions that lack evidence of commercial rationale and/or substance can trigger the application of other provisions, including the "reconstruction" provision in the transfer pricing rules and anti-avoidance provisions such as GAAR or DPT.

The ATO briefly outline in TA 2020/1 some of the typical features of arrangements that may be of concern. A number of those features are set out in the three examples included in TA 2020/1 (the examples are summarised further below). The key features which are of interest to the ATO include the following:

- lack of substance in the foreign entity, including limited direction and control over the DEMPE of the intangible assets, limited qualified staff, lack and/or inability to manage/assume risks and/or contribute assets;
- misalignment between the substance and form of the arrangement, in particular where an Australian entity performs activities, assumes risks and contributes assets beyond those contemplated by the legal form of the arrangement;
- absence of compensation for "migration" or transfers of intangibles assets, whether at a given point in time or over time;
- lack of commercial rationale for the arrangement; and
- inconsistency between the substance of the arrangements and the best economic interest of an Australian entity.

Interestingly, the ATO note in TA 2020/1 that it is in the process of developing its technical position in relation to these types of arrangements and that it will continue to do so through engagement with taxpayers. In this context, TA 2020/1 is not intended to provide the ATO's technical view on the various matters detailed therein. The examples are based on arrangements of concern, but arrangements are not limited to those described in the Taxpayer Alert and "are not confined to a specific form of arrangement".

The ATO also notes that taxpayers that enter into the type of arrangements described in TA 2020/1 will be subject to increased scrutiny and the ATO encourages taxpayers to proactively engage with them. We expect further guidance to be issued by the ATO, likely a Practical Compliance Guideline ("PCG"). Taxpayers can expect the ATO to have regard to the PCG in tailoring their engagement with taxpayers.

Examples

The ATO provides three examples in TA 2020/1 to illustrate typical arrangements with cause for concern.

Example 1: Arrangements involving the bifurcation of intangible assets and mischaracterisation of Australian DEMPE activities. In this example, an Australian entity owning intangible assets (the "existing intangibles") enters into a contract research and development ('R&D') arrangement with a foreign related party for the development of new intangibles intrinsically linked to the existing intangibles. The foreign related party performs limited activities related to the development of the new intangibles, while the

Australian entity's activities in relation to the new intangibles are not materially different to those it performed in relation to the existing intangibles. In addition, the value of the existing intangibles decreases over time as no more DEMPE functions are performed in relation to those intangibles.

In addition to the potential mischaracterisation of the Australian DEMPE functions, the ATO has also indicated that the above "migration" may alternatively be characterised as a disposal for the purposes of the capital gains tax ("CGT") and capital allowance provisions and therefore give rise to a CGT event or balancing adjustment event respectively.

ATO concerns regarding intangibles migration were also earlier addressed in the context of the diverted profits tax within *PCG 2018/5*. In the draft version of PCG 2018/5, the ATO described an arrangement (near equivalent to TA 2020/1 Example 1) as an example of high-risk, 'run up, run down' intangibles migration. PCG 2018/5 also described a modified low-risk example where the transfer pricing rules, CGT rules and R&D integrity rules were applied appropriately.

The second and third examples of TA 2020/1 relate to arrangements involving the non-recognition of Australian DEMPE activities.

Example 2: An Australian entity is a party to a cost contribution arrangement ("CCA") in relation to the DEMPE functions for intangible assets. In substance, the Australian entity's contributions exceed those provided for in the relevant CCA agreement and that the corresponding benefit received is not commensurate with this contribution vis-a-vis other related parties within the CCA.

Example 3: An Australian entity pays a royalty to a foreign related party for the use of intangible assets. The global group stores intangible assets in an online database.

The Australian entity and the foreign related party also enter into an arrangement for the provision of contract R&D services by the Australian entity. The Australian entity is required to share all know-how developed in the course of its activities. The foreign entity has limited operations, staff and assets, while the Australian entity performs the DEMPE functions associated with the intangible assets with limited management and control from the foreign entity.

ATO's stated response

The ATO is in the process of reviewing these arrangements and engaging with taxpayers who have entered into, or are considering entering into, these arrangements. The ATO's engagement and assurance activities will continue while the ATO develops its technical position on these arrangements.

The ATO is encouraging taxpayers that have entered into, or are contemplating entering into, an arrangement of the type covered by TA 2020/1 to discuss their situation with the ATO by emailing *PGIIntangiblesMigration@ato.gov.au*.

Our observations

1. Scope - The potential scope of TA 2020/1 is broad, conceivably calling into question a wide range of transactions, including cross-border related party contract R&D arrangements, licensing arrangements and any other arrangements involving the performance of DEMPE activities by an Australian taxpayer in connection with intangible assets.
2. Transparency - Information required to identify arrangements in scope is already available to the ATO (for example, through the International Dealings Schedule and/or CBC Local File / Master File). Taxpayers with arrangements potentially within the scope of TA 2020/1 should therefore evaluate their position and options to mitigate any potential risk.
3. Additional disclosure - It is likely that arrangements targeted by TA 2020/1 or the anticipated PCG will need to be disclosed in the RTP schedule in the future. The ATO's RTP schedule instructions call for a very wide interpretation of Taxpayer Alerts, which may result in a number of taxpayers being required to disclose relatively lower risk arrangements involving intangibles, including contract R&D arrangements.

4. Evidence - Whilst TA 2020/1 states that arrangements of concern are not limited to the examples, the examples contained in TA 2020/1 are relatively polarised in order to draw out key points of ATO emphasis. Taxpayers who review their relevant scenarios may find that their own arrangements reflect more complex and less binary fact patterns. As a result, taxpayers should undertake a detailed facts-based analysis, collating evidence of key assertions and the commercial rationale underpinning their arrangements, in order to determine the appropriateness of any filing position from an Australian tax perspective and prepare for potential ATO engagement.

The takeaway

Taxpayer Alerts provide clear signals of current and continuing ATO areas of focus. Given heightened transparency levels and disclosure requirements, taxpayers potentially within the scope of TA 2020/1 should proactively analyse their arrangements, collate factual evidence around key assertions, assess their filing position and determine their tax authority engagement strategy to ensure they are prepared for any potential ATO engagement.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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