Undivided payments for goods and services involving a royalty component

29 November 2018

Explore more insights 365

In brief

The Australian Taxation Office (ATO) has recently released a new Taxpayer Alert (TA 2018/2) on international arrangements involving undivided payments for products or services where part of that payment relates to an intangible right such as the use of know-how or trademarks.

There may be a variety of possible consequences for taxpayers, including:

- the retrospective application of royalty withholding tax with an unlimited amendment period
- denial of previously claimed deductions on royalties paid
- adjustments for transfer pricing benefits
- additional income being attributed to Australia under the controlled foreign company rules
- application of anti-avoidance rules, including the Diverted Profits Tax, and
- double taxation in cases of inconsistent interpretations by countries.

Since Taxpayer Alerts are a summary of the ATO's concerns about new or emerging higher risk tax arrangements or issues which may come under increased scrutiny by the Commissioner of Taxation, potentially affected taxpayers should review their current arrangements to determine if they fall into the circumstances described in the Taxpayer Alert and consider appropriate action to be taken. The review of such arrangements should also consider disclosure requirements in the Reportable Tax Position Schedule that may be required to be lodged with tax returns.

In detail

Taxpayer Alert, TA2018/2, outlines the ATO's concerns in relation to international arrangements that mischaracterise intangible assets and/or activities or conditions connected with intangible assets. Specifically, the ATO notes that mischaracterisation is more likely to arise under arrangements that allocate all consideration to tangible goods and/or services, those that allocate no consideration to intangible assets, and arrangements that view intangible assets collectively, or conceal intangible assets.

The ATO has stated that these 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 jurisdiction (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 recognise or treat as wholly or partly being for the use of an IP entity's intangible assets.

The Taxpayer Alert is stated not to apply to international arrangements which involve an 'incidental use' of an intangible asset (e.g. 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). However, the fact that an arrangement fails to expressly provide for the use of an intangible asset does not, in itself, determine that a use is incidental.

In relation to arrangements between both related and unrelated parties, the ATO has expressed its concerns about:

- whether intangible assets have been appropriately recognised for Australian tax purposes, and
- whether Australian royalty withholding tax obligations have been met.

Where arrangements are between related parties, the ATO is concerned about whether the:

- amount deducted by the Australian entity under the arrangement meets the arm's length requirements of the transfer pricing provisions in the taxation law, and
- functions performed, assets used and risks assumed by the Australian entity, in connection with the arrangement, are appropriately compensated in accordance with the arm's length requirements of the transfer pricing provisions in the taxation law.

It is important to note that Taxpayer Alerts **do not** provide the ATO's view on the arrangements they describe, or on tax technical or tax administrative issues arising from those arrangements. Rather, Taxpayer Alerts address situations where there is currently no ATO view and where we might expect to see the ATO's considered position in the future.

The ATO has provided two example arrangements in the Taxpayer Alert.

The first relates to an Australian manufacturing and distribution entity that pays undivided consideration for tangible goods, trademarks and know-how to an unrelated foreign entity, and no Australian withholding tax is remitted.

The second involves related party arrangements between members of a multinational group. In this example, the Australian entity pays for management services from an offshore parent entity and supplies of tangible goods from another offshore, related or unrelated, entity. A third offshore IP ownership entity grants a related party exclusive use of IP in the territory of Australia but the offshore IP entity does not enter into any agreement with the Australian entity.

Our insights

1. The ATO will be looking at the substance of activities and dealings, not just the contractual arrangements.

2. Royalty withholding tax may apply to the part of the undivided payment that relates to the use of know-how/trademarks. This may apply to both related party and unrelated party transactions. The Commissioner has an unlimited period of review in relation to withholding tax.

3. Where payments are considered to constitute a royalty derived by an offshore subsidiary, taxpayers will need to consider whether this has implications under the controlled foreign companies (CFC) rules.

4. Previously claimed deductions for these undivided payments which include a royalty component may be disallowed both in related party or unrelated party transactions. Deductions for royalties paid by taxpayers are generally not deductible until royalty withholding tax has been paid.

5. The amount of the deduction for these undivided payments and/or the profits of the Australian entity may be subject to adjustments under the transfer pricing provisions where they are determined to not reflect arm's length requirements. The Commissioner has an extended period of review in relation to transfer pricing.

6. The potential application of the general anti-avoidance provisions, including the Diverted Profits Tax, where these arrangements are entered into for the sole, dominant or principal purpose of obtaining a tax benefit.

7. The concept of royalty as suggested in the Taxpayer Alert, in many cases, may be inconsistent with the interpretation adopted by Australia's treaty partners leading to the likely need to resolve double taxation outcomes. It would also seem to have a range of other consequences, including the potential for additional foreign taxes on Australian exporters of goods and services using intangible assets.

8. The ATO continues to develop its technical position on these arrangements. There are some flow-on issues for which guidance will need to be developed, for example, in relation to determining whether the use of trademarks/know-how is 'incidental' and issues with apportionment, if any, of these undivided payments as there may be practical difficulties in valuing the right to use trademarks and know-how under an apportionment approach.

The takeaway

Taxpayer Alerts are particularly relevant for Top 1000 reviews being conducted by the ATO and Reportable Tax Position disclosures. We suggest that taxpayers review their current agreements and actual practices to see if they fall within the scope of the Taxpayer Alert and determine the next steps that need to be taken.

Let's talk

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

Eddy Moussa, Sydney
+61 (2) 8266 9156
eddy.moussa@pwc.com

Paul McNab, Sydney
+61 (2) 8266 5640
paul.mcnab@pwc.com

Lyndon James, Sydney
+61 (2) 8266 3278
lyndon.james@pwc.com

Greg Weickhardt, Melbourne
+61 (3) 8603 2547
greg.weickhardt@pwc.com

Peter Collins, Melbourne
+61 438624700
peter.collins@pwc.com

James Nickless, Sydney
+61 (2) 8266 3246
james.nickless@pwc.com

Jonathan Malone, Sydney
+61 (2) 8266 4770
jonathan.r.malone@pwc.com

Angela Danieletto, Sydney
+61 (2) 8266 0973
angela.danieletto@pwc.com

WL127057726