



Taxpayer Alert

Research and development activities delivered by associated entities

! About Taxpayer Alerts

Alerts provide a summary of our concerns about new or emerging higher risk tax or superannuation arrangements or issues that we have under risk assessment.

While an Alert describes a type of arrangement, it is not possible to cover every potential variation of the arrangement. The absence of an Alert on an arrangement or a variation of an arrangement does not mean that we accept or endorse the arrangement or variation, or the underlying tax consequences.

Refer to [PS LA 2008/15](#) for more information about Alerts. See [Alerts](#) issued to date.

Table of Contents	Paragraph
Overview	1
Description	4
What are our concerns?	6
What are we doing?	8
What should you do?	12
Do you have information?	15

Overview

1. We are currently reviewing claims made by research and development (R&D) entities¹ for a tax offset under the R&D tax incentive (R&DTI) for expenditure incurred under an agreement with an associate² of the R&D entity (the Service Provider) who itself conducts the R&D activities.
2. We are concerned with arrangements that:
 - incorrectly purport the R&D entity as having incurred or paid (or both) the relevant expenditure under an agreement with the Service Provider, or
 - have the effect of obtaining for the R&D entity a tax offset for expenditure on R&D activities purportedly conducted for the R&D entity's own benefit but are instead in substance being conducted for (or to a significant extent, for) the Service Provider.
3. The Service Provider is usually an entity that has historically conducted the group's trading and research activities. The Service Provider however is not itself an entity that

¹ As defined in section 355-35 of the *Income Tax Assessment Act 1997*.

² As defined in section 318 of the *Income Tax Assessment Act 1936*.

would be entitled to claim an offset were it to conduct the activities for its own benefit, or if entitled, only entitled to a lesser benefit under the R&DTI.³

Description

4. Arrangements of concern are commonly structured as follows.

- The Service Provider or its controllers:
 - cause the incorporation of a special purpose company, or
 - repurpose an existing non-trading company within the controlled group

to be the controlled group's R&D entity.
- The Service Provider:
 - as contractor, conducts R&D activities under a service agreement with the R&D entity as principal
 - itself funds the R&D activities being conducted, before purportedly invoicing the R&D entity a service fee or recharge amount for having conducted the activities
 - in substance and effect
 - controls the strategic decisions regarding the R&D activities
 - has primary rights to commercially exploit for the purposes of its own trading business any developed intellectual property (IP), know-how or other results (including data) from the R&D activities having been conducted (the Developed IP).
- The R&D entity:
 - conducts limited or no other activity other than the R&D-specific arrangements under the service agreement entered into with the Service Provider
 - purports to satisfy its service payment obligations to the Service Provider by
 - a loan or other financing facility between the R&D entity (as borrower) and the Service Provider or related party (as lender)
 - set-off against a new licence arrangement for exploitation of the Developed IP between the R&D entity (as licensor) and the Service Provider (as licensee), or
 - set-off against other intra-group sales or service agreements between the R&D entity and the Service Provider
 - has few (if any)
 - employees with the technical capability to itself design, conduct or supervise any R&D activities being conducted

³ For example, the Service Provider might be a trust and therefore ineligible itself to claim an R&D tax offset under the R&DTI.

- sufficiently liquid assets of value capable of being provided as security or capable of realisation to service any indebtedness to the Service Provider
 - in the absence of any original and future committed funding from the Service Provider, lacks the economic capacity to either conduct the R&D activities, or commercially exploit the Developed IP.
 - In substance and effect, the refundable tax offset⁴ is the R&D entity's only receipt and the only amount used to service the R&D entity's payment obligations to the Service Provider.
 - The agreements between the Service Provider and the R&D entity might not be reduced to writing, and if in writing may have a legal form that, on review, is inconsistent with the actual commercial substance of the arrangement between the entities.
5. These arrangements may involve the following variations:
- two or more related entities⁵, including 3-way arrangements within the group
 - purported satisfaction of the R&D entity's service payment obligations to the Service Provider by way of fresh share issue in the R&D entity to the Service Provider either
 - at the time of invoicing, or
 - later when the then unpaid debt owed by the R&D entity is converted to shares
 - service payment obligations met through various payment options in rapid succession through a circular flow of funds, or longer-term funding purporting to be general working capital.

What are our concerns?

6. Depending on the arrangement, we consider that entitlement to the R&DTI may in whole or part be affected because:
- Any obligation to pay the Service Provider is so impacted by future events or contingencies that it cannot be concluded that the R&D entity is definitively committed to its obligation to pay and thereby having actually incurred the relevant expenditure such that a notional deduction arises.
 - Although the expenditure on R&D activities is incurred, it was neither
 - paid, nor
 - constructively paid
 by the R&D entity to the Service Provider in the relevant income year as required under the law.

⁴ Together with possible refunds under Division 35 of the *A New Tax System (Goods and Services Tax) Act 1999* for input tax credits on purported creditable acquisitions for expenditure incurred to the Service Provider.

⁵ Be they associates or connected and affiliated entities under sections 328-125 and 328-130 of the *Income Tax Assessment Act 1997* respectively.

- The expenditure on R&D activities does not satisfy the conditions for R&D activities because it was either
 - not conducted for the R&D entity, or
 - conducted to a significant extent for the Service Provider and that entity does not meet the statutory conditions for eligible R&D activities.
- Where a notional deduction for expenditure on R&D activities to the Service Provider does qualify for the R&DTI
 - that expenditure amount may be reduced to the market value of the R&D activities being conducted by the Service Provider for the R&D entity, or
 - that notional deduction might be reduced to reflect any mark-up on the expenditure incurred by the Service Entity and charged to the R&D entity under the agreement.
- If the R&D entity is an Australian resident, it might still not qualify for an R&D tax offset for some (or all) of its expenditure, if on review, that expenditure is not 'at risk' for the purposes of the 'at risk' integrity rule in the R&D provisions.

7. Even if an arrangement is effective under the substantive provisions, if viewed objectively that one or more parties to the arrangement entered into or carried out the arrangement for the purpose of obtaining a tax offset, the general anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936* may apply to cancel that tax offset.

What are we doing?

8. We are currently reviewing these arrangements and are engaging with taxpayers who have entered into, or are considering entering into, these and similar arrangements.

9. Taxpayers and advisers who enter into these types of arrangements will be subject to increased scrutiny.

10. We are developing further website guidance on specific technical matters in this Alert that will be published in due course.

11. We have also issued Taxpayer Alert TA 2023/5 *Research and development activities conducted overseas for foreign related entities*.

What should you do?

12. If you have entered, or are contemplating entering, into an arrangement of this type, we encourage you to:

- phone or email us using the contact details provided at the end of this Alert
- ask us for our view through a [private ruling](#)
- seek independent professional advice
- make a [voluntary disclosure](#) to reduce penalties that may apply.

13. Penalties may apply to participants in, and promoters of, this type of arrangement. This includes serious penalties for promoters under Division 290 of Schedule 1 to the *Taxation Administration Act 1953*. Registered tax agents involved in the promotion of this

type of arrangement may be referred to the Tax Practitioners Board to consider whether there has been a breach of the *Tax Agent Services Act 2009*.

14. For more information about eligible R&D activities, what can be claimed under the R&DTI and record keeping, refer to [Research and development tax incentive](#).

Do you have information?

15. To provide information about this type of arrangement, or a promoter of this or another arrangement:

- phone us on **1800 060 062**
- contact the officer named in this Alert.

Contact officer: Jared Birbeck

Email: InnovationTax@ato.gov.au

Commissioner of Taxation

14 December 2023

References

Legislative references:

- ITAA 1936 Pt IVA
- ITAA 1936 318
- ITAA 1997 328-125
- ITAA 1997 328-130
- ITAA 1997 355-35
- TAA 1953 Sch 1 Div 290
- Tax Agent Services Act 2009

- ANTS(GST)A 1999 Div 35

Related practice statements

- PS LA 2005/24

Other references

- TA 2023/5
-

ATO references

NO: 1-ZZ1FN1S

ISSN: 2651-9550

BSL: PW

ATOlaw topic: Income tax ~~ Research and development ~~ Expenditure ~~ Conditions for research and development activities

© AUSTRALIAN TAXATION OFFICE FOR THE COMMONWEALTH OF AUSTRALIA

You are free to copy, adapt, modify, transmit and distribute this material as you wish (but not in any way that suggests the ATO or the Commonwealth endorses you or any of your services or products).