



TA 2009/21 - R&D tax offset abuse through registered research agencies

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Taxpayer Alert

TA 2009/21

FOI status: may be released

Taxpayer Alerts are intended to be an "early warning" of significant new and emerging tax planning issues or arrangements that the ATO has under risk assessment.

Taxpayer Alerts will provide information that is in the interests of an open tax administration to taxpayers. Taxpayer Alerts are written principally for taxpayers and their advisers and they also serve to inform ATO officers of new and emerging tax planning issues. Not all potential tax planning issues that the ATO has under risk assessment will be the subject of a Taxpayer Alert, and some arrangements that are the subject of a Taxpayer Alert may on further examination be found not to be of concern to the ATO.

Taxpayer Alerts will give the title of the issue (which may be a scheme, arrangement or particular transaction), briefly describe the issue and will highlight the features which the ATO considers give rise to taxation and superannuation regulatory issues. These issues will generally require more detailed analysis to provide an ATO view to taxpayers.

The developers and marketers of an arrangement which is the subject of a Taxpayer Alert should provide the full facts of the arrangement to the ATO to enable the ATO to finalise its view.

Taxpayers who have entered into or are contemplating entering into an arrangement similar to that described in this Taxpayer Alert might obtain their own advice or contact the Tax Office to seek guidance in relation to the income tax and superannuation regulatory issues covered in the Taxpayer Alert.

This Taxpayer Alert is issued under the authority of the Commissioner.

TITLE: R&D tax offset abuse through registered research agencies

This Taxpayer Alert is concerned with the Research and Development ('R&D') tax offset allowable under certain conditions to eligible companies. These companies can choose the tax offset rather than a tax deduction for their R&D expenditure, if their aggregate research and development amount is not more than \$1 million per year for the 2009 and prior income years and \$2 million per year for the 2010 income year.

The R&D rules also allow a concession for prepayments of 'contracted expenditure' to a research agency registered under the *Industry Research and Development Act 1986*.

Some companies have been identified as structuring contracts with a registered research agency ('RRA') to take advantage of the prepayment concession, but they may not be eligible for the tax offset.

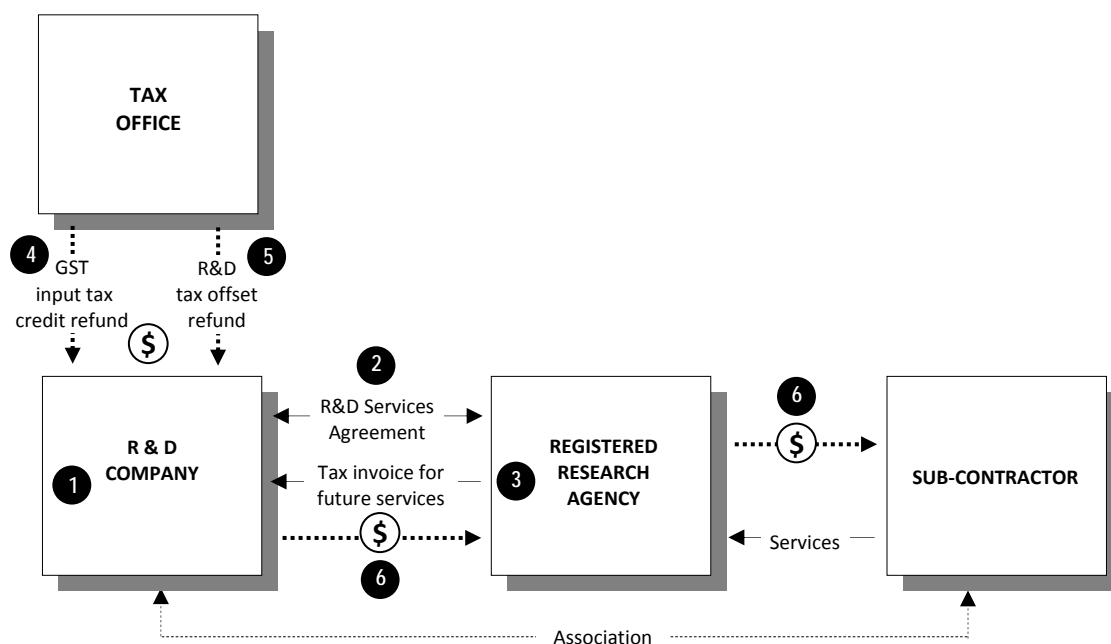
DESCRIPTION

This Alert applies to arrangements that have features that are substantially equivalent to the following:

1. A company is incorporated with a minimal amount of paid-up capital. The company accounts for GST and income tax on an accruals basis but generates negligible income.
2. The company enters an R&D services agreement with an RRA for the provision of R&D services for a period of up to 13 months, often within the last month of an income year. The agreement provides that the RRA will manage the R&D project and will engage sub-contractors to perform the work required under the agreement. The sub-contractors often may be associated with the company.
3. The RRA issues a tax invoice for an amount up to \$1,100,000¹ for the provision of future R&D services.
4. The RRA does not commence services, or provides only insignificant services, in the income year that the agreement is signed and the tax invoice is issued. The company makes no payments in respect of the agreement in that income year and the entire amount is said to have accrued.
5. The company lodges a Business Activity Statement ("BAS") for the period in which it received the tax invoice from the RRA and claims an input tax credit relating to the invoice. The company receives a refund of up to \$100,000 ($\$1,100,000 \times 1/11$).
6. The company lodges its income tax return for the year in which it entered into the agreement with the RRA and reports that it has contracted expenditure to an RRA of an amount up to \$1,000,000. The company elects to receive the R&D tax offset of up to \$375,000 rather than a tax deduction ($\$1,000,000 \times 125\% \times 30\%$).
7. The company applies funds from the GST refund and R&D tax offset to the balance owing under the R&D services agreement with the RRA.
8. In some instances funding arrangements to the company are provided by the RRA or parties associated with the RRA. This creates round robin cash-flows among the company, RRA and the parties associated with the RRA or the company.

¹ This relates to the maximum amount of expenditure that can be claimed in relation to the 2009 and earlier income years (\$1,000,000). For the 2010 income year the amount has been increased to \$2,000,000

DIAGRAM OF A TYPICAL ARRANGEMENT



- 1 A company is incorporated with a minimal amount of paid-up capital. The company accounts for GST and income tax on an accruals basis but generates negligible income.
- 2 The company enters an R&D services agreement with an RRA for the provision of R&D services. The RRA will manage the R&D project and engage sub-contractors to perform the work required under the agreement. The sub-contractors often may be associated with the company.
- 3 The RRA issues a tax invoice for the provision of future R&D services. The company makes no payments in the initial income year and the entire amount is accrued.
- 4 The company lodges a Business Activity Statement ('BAS') for the period in which it received the tax invoice from the RRA and claims an input tax credit relating to the invoice.
- 5 The company lodges its income tax return for the year in which it entered into the agreement with the RRA and elects to receive the R&D tax offset rather than a tax deduction.
- 6 The R&D company uses the tax refunds to pay the RRA which then initiates the sub-contractor services previously invoiced by the RRA.

FEATURES WHICH CONCERN US

The Tax Office considers that arrangements of this type give rise to the following income tax issues, of whether:

- a. the transaction, or certain steps within it, may be a sham at general law;
- b. the expenditure may have been 'incurred' for the purposes of subsection 73B(13) of the *Income Tax Assessment Act 1936* (ITAA 1936);
- c. the expenditure may have the character of 'contracted expenditure' for the purposes of subsection 73B(13) of the ITAA 1936;
- d. the expenditure, if not 'contracted expenditure', is otherwise 'research and development expenditure', deductible under subsection 73B(14) of the ITAA 1936;
- e. the prepayment rules in Subdivision H of Division 3 of Part III of the ITAA 1936 apply;

- f. the company and the RRA dealt with each other at arm's length in relation to purported R&D expenditure;
- g. the Commissioner ought to form an opinion under subsection 73B(31) of the ITAA 1936 of the 'reasonable' amount of expenditure to be allowed, if the parties had dealt at arm's length;
- h. the RRA's are including fees, payments or commissions received under the arrangement as assessable income under section 6-5 of the ITAA 1997; and
- i. any entity involved in the arrangement may be a promoter of a tax exploitation scheme for the purposes of Division 290 of Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953).

The Tax Office is currently reviewing these arrangements.

Note 1: *Base penalties of up to 75% of the tax avoided can apply where you make a false and misleading statement to the Commissioner. Reductions in base penalty will be available if the taxpayer makes a voluntary disclosure to the Tax Office. If you would like to make a voluntary disclosure or have any information about the current arrangement, phone us on 1300 365 803.*

Note 2: *Penalties of up to 5,000 penalty units for individuals, 25,000 penalty units for bodies corporate or up to twice the amount of consideration received or receivable may apply to promoters of tax exploitation schemes under Division 290 of Schedule 1 to the Taxation Administration Act 1953. The Commissioner can also apply to the Federal Court of Australia for restraining and performance injunctions against promoters where prohibited conduct has occurred, is occurring or is proposed.*

Note 3: *In appropriate cases, sanctions under criminal law may also apply. Where a taxpayer makes a voluntary disclosure and that disclosure indicates possible criminal offences, the Commonwealth Director of Public Prosecutions has indicated that favourable consideration will be given to granting an indemnity from criminal prosecution in relation to the taxpayer's involvement in the scheme where:*

- *the case does not exhibit a significant degree of criminality by the taxpayer*
- *the taxpayer provides information about how the arrangements worked, including the role and identity of the promoter, and*
- *the taxpayer co-operates with the investigation and consequential proceedings.*

Note 4: *A registered tax agent may have their registration cancelled or suspended by the Tax Agents' Board under section 251K of the Income Tax Assessment Act 1936 if they are guilty of misconduct as a tax agent or are not considered a fit and proper person to prepare income tax returns. A person under a sentence of imprisonment for a serious taxation offence is not a fit and proper person.*

Note 5: *The Commissioner may amend an assessment at any time to disallow a claim for R&D tax deductions or the R&D tax offset. The Commissioner may also amend an assessment at any time where he is of the opinion there has been avoidance of tax due to fraud or evasion. See Law Administration Practice Statement PSLA 2008/6.*

Subject References:

Aggressive tax planning
Research and development expenses
Research and development tax offset
R&D contracted expenditure

Legislative References:

Income Tax Assessment Act 1936

Section 73B

Subsection 73B(13)

Subsection 73B(14)

Subsection 73B(31)

Subdivision H Division 3 of Part III

Income Tax Assessment Act 1997

Section 6-5

Industry Research and Development Act 1986

Taxation Administration Act 1953

Division 290

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