TA 2020/1 - Non-arm's length arrangements and schemes connected with the development, enhancement, maintenance, protection and exploitation of intangible assets

Non-arm's length arrangements and schemes connected with the development, enhancement, maintenance, protection and exploitation of intangible assets

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.

Description

We are currently reviewing international arrangements that mischaracterise Australian activities connected with the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangible assets.[1] We are concerned that these arrangements may be non-arm's length or structured to avoid tax obligations, resulting in inappropriate outcomes for Australian tax purposes.

Our concerns include whether functions performed, assets used and risks assumed by Australian entities in connection with the DEMPE of intangible assets are properly recognised and remunerated in accordance with the arm's length requirements of the transfer pricing provisions in the taxation law.[2]

We are also concerned that parties to these arrangements may fail to properly comply with Australian income tax obligations such as those imposed by the capital gains tax[3] (CGT) and capital allowances[4] provisions. We are particularly concerned where intangible assets

[1] Intangible assets being property, assets and rights that are not physical assets or financial assets, which are capable of being controlled for use in commercial activities as defined in paragraph 6.6 of Revisions to Chapter VI of the Transfer Pricing Guidelines (OECD, 2015, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris), see section 815-135 of the *Income Tax Assessment Act 1997* (ITAA 1997). It is noted that, at the time of publication of this Alert, the Treasury has completed a consultation process (Miscellaneous amendments to Treasury portfolio laws 2019) containing in part a Miscellaneous Amendments Bill Exposure Draft which includes amendments to section 815-135 of the ITAA 1997. The Exposure Draft includes amendments which, if enacted, repeal section 815-135(2)(aa) of the ITAA 1997 regarding the OECD's Actions 8-10 - 2015 Final Reports and revise section 815-135(2)(a) of the ITAA 1997 to incorporate the OECD, 2017, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing, Paris, as approved by the Council of the OECD and last amended on 19 May 2017.

[2] As outlined in Division 815 of the ITAA 1997. 'Taxation law' is defined in subsection 995-1(1) of the ITAA 1997.

[3] As outlined in Parts 3-1 and 3-3 of the ITAA 1997.

[4] As outlined in Division 40 of the ITAA 1997.

and/or associated rights are migrated[5] to international related parties as part of non-arm's length arrangements and/or in a manner intended to avoid Australian tax.

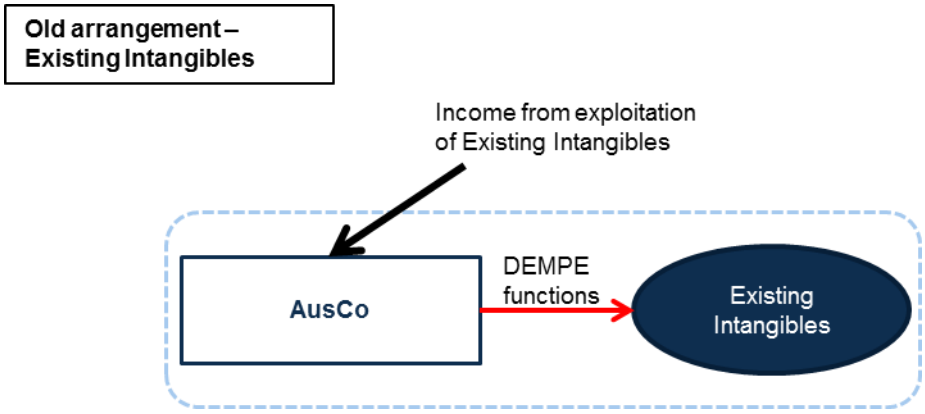
In circumstances where these arrangements lack evidence of commercial rationale and/or substance, our concerns will extend to the application of the exceptions in the transfer pricing provisions[6] and anti-avoidance rules.[7] The general anti-avoidance rule (GAAR)[8] or diverted profits tax (DPT) provisions[9] may apply where a tax benefit or DPT tax benefit is obtained in connection with these arrangements.

Arrangements of particular concern include, but are not limited to, those described in this Alert.

Arrangement 1 – arrangements involving the bifurcation of intangible assets and mischaracterisation of Australian DEMPE activities

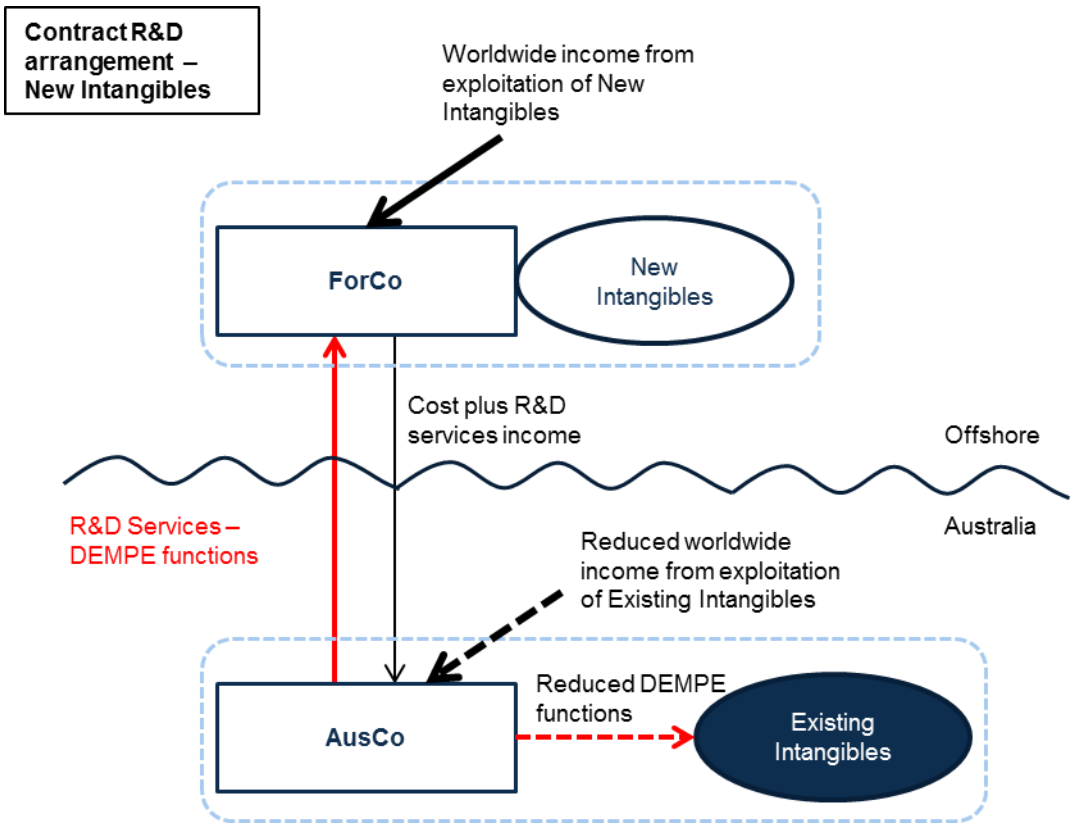
We are concerned that entities may enter into arrangements which inappropriately bifurcate intangible assets and mischaracterise DEMPE activities associated with those assets. An example of such an arrangement is depicted below.

Arrangement 1 example



An Australian company (AusCo) manages, performs and controls activities and risks associated with the DEMPE of valuable patents, trade marks, know-how, copyright and like assets (Existing Intangibles). AusCo owns the Existing Intangibles and derives income from their exploitation.

[5] A 'migration' refers to any transaction(s) that allows an entity to access, hold, use, transfer, or obtain benefits in connection with, intangible assets and/or associated rights.
[6] See subsections 815-130(2) to (4) of the ITAA 1997.
[7] As outlined in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936).
[8] As outlined in Part IVA of the ITAA 1936.
[9] As outlined in Part IVA of the ITAA 1936. Further information concerning the application of the DPT to cross border arrangements in connection with intangible assets is available in Practical Compliance Guideline PCG 2018/5 *Diverted profits tax* and Law Companion Ruling LCR 2018/6 *Diverted profits tax*.



AusCo enters into a contract research and development (R&D) arrangement with a foreign related company (ForCo). Pursuant to this arrangement, AusCo provides services to ForCo associated with the DEMPE of potentially new or future intangible assets (New Intangibles). AusCo is remunerated by ForCo on a cost plus basis. All New Intangibles produced under the arrangement are owned by ForCo. ForCo derives all income generated from the exploitation of the New Intangibles.

AusCo continues to receive income derived from the exploitation of the Existing Intangibles but reduces or ceases its DEMPE activities associated with the Existing Intangibles.

The New Intangibles are intrinsically linked to AusCo's Existing Intangibles comprising updated versions and enhancements of the patents, trade marks, know-how, copyright and like assets, which form part of, and are connected to, AusCo's Existing Intangibles.

The functions performed, assets used and risks assumed by AusCo do not materially change in substance following the execution of the contract R&D arrangement. AusCo continues to employ the same specialised staff and use its expertise and assets associated with the Existing Intangibles to manage, perform and control DEMPE activities associated with the New Intangibles.

ForCo manages and performs limited activities and assumes limited risks in connection with the New Intangibles. At the time the contract R&D arrangement commences, ForCo does not have sufficient assets or employ sufficient suitably qualified staff to properly or primarily manage, perform or control the DEMPE of the New Intangibles. AusCo continues to be best placed to manage, perform and control DEMPE activities given the functions performed, assets used and risks assumed by AusCo.

The value of the Existing Intangibles and income derived by AusCo from their exploitation declines due to the reduction in or cessation of DEMPE activities in connection with the Existing Intangibles. The value of the New Intangibles and associated income streams derived by ForCo increases as a result of the DEMPE activities performed by AusCo.

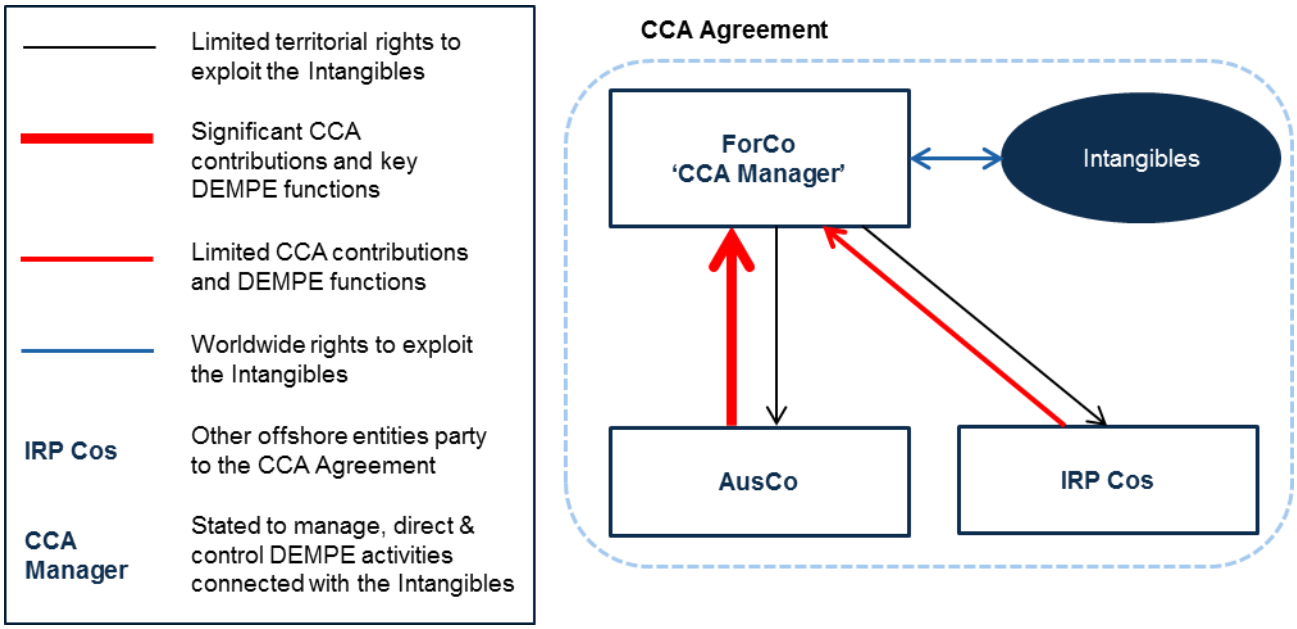
AusCo's remuneration under the contract R&D arrangement with ForCo does not reflect the extent or character of functions performed, assets used and risks assumed by AusCo in connection with the New Intangibles or the connection between the New Intangibles and AusCo's Existing Intangibles, which are intrinsically linked. In these circumstances, the conditions operating in connection with the arrangement may not be consistent with arm's length conditions for the purposes of Australia's transfer pricing laws. Additionally, AusCo may not have properly complied with Australian CGT and capital allowances obligations, including where intangible assets have been migrated to ForCo as a result of the arrangement.

Where AusCo's entry into the arrangement exhibits a lack of commercial rationale or is not consistent with its best economic interests having regard to the commercial options realistically available, the exceptions in the transfer pricing provisions and the GAAR or DPT provisions may apply. In these circumstances, the arrangement may have been entered into or carried out for the sole, dominant or principal purpose, or for more than one principal purpose that includes a purpose of obtaining a tax benefit or DPT tax benefit[10]*, within the meaning of Australia's GAAR and DPT provisions.*

Arrangement 2 – arrangements involving the non-recognition of Australian DEMPE activities

We are concerned that entities may enter into arrangements connected with the DEMPE of intangible assets that do not appropriately recognise Australian contributions to DEMPE functions for tax purposes. Our concerns, whilst not confined to a specific form of arrangement, include that the benefits obtained by Australian entities under such arrangements may not reflect the value of Australian contributions in the form of DEMPE activities and/or pre-existing intangible assets. This is of particular concern where the division of the right(s) to exploit intangible assets associated with these arrangements does not result in Australian entities receiving an appropriate or proportionate share of global income from the exploitation of such assets. Two examples of such arrangements are depicted below.

Arrangement 2 – example 1



[10] Or both to obtain a tax benefit and to reduce one or more of the parties' liabilities to tax under a foreign law, see Part IVA of the ITAA 1936.

An Australian company (AusCo) is party to a cost contribution arrangement[11] (CCA) with a number of related foreign companies. The CCA agreements (CCA Agreement) provide that the participants will contribute resources and perform activities associated with the DEMPE of intangible assets (CCA Contributions) for the mutual benefit of all participants.

The CCA Agreement states that one of the foreign related companies (ForCo):

- *manages, directs and controls activities associated with the DEMPE of intangible assets, including allocating R&D activities to the CCA participants, managing and directing such R&D activities and assuming associated risks*
- *determines and receives CCA Contributions from the participants according to an allocation key*
- *obtains the worldwide rights to exploit all intangible assets developed under, and associated with, the CCA, subject to rights granted to the other CCA participants in their respective jurisdictions*
- *registers and protects all intangible assets developed under, and associated with, the CCA.*

In exchange for the CCA Contributions, the participants, including AusCo, each obtain from ForCo the right to exploit all intangible assets associated with the CCA in their respective jurisdictions. The intangible assets covered by the CCA Agreement include patents, trade marks, copyright, know-how, and like assets.

The form of the CCA Agreement states that AusCo:

- *provides funds to, and/or receives funds from, ForCo (as CCA Contributions)*
- *contributes intangible assets developed by AusCo (as CCA Contributions)*
- *incurs costs in undertaking and managing R&D activities to develop, enhance and/or commercialise patents, trade marks, copyright, know-how, and like assets as directed by ForCo*
- *uses intangible assets subject to the CCA to derive income in the Australian market.*

In substance, AusCo undertakes and manages extensive R&D activities relative to the other participants in the CCA, assumes associated risks, and develops and commercialises new patents, trade marks, copyright, know-how and like assets. To do this, AusCo uses assets and employs specialised staff. AusCo applies its specialist expertise to manage risks and is subject to minimal direction and oversight from ForCo. This results in the development and enhancement of valuable intangible assets that are exploited by ForCo and the other related foreign companies party to the CCA Agreement (IRP Cos) in other jurisdictions to derive income.

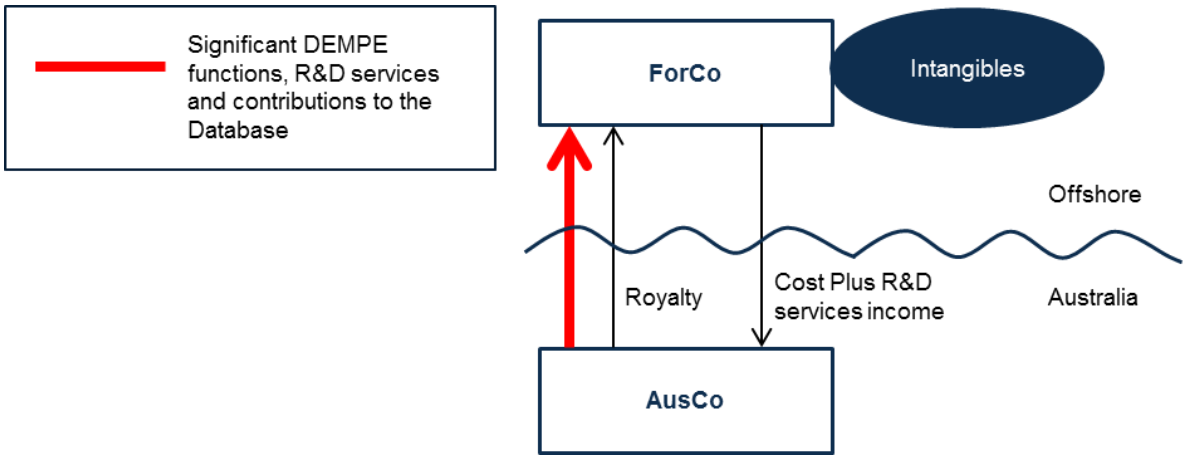
ForCo employs limited staff and contributes limited funds and/or assets under the CCA arrangement. Limited contributions are also made by the IRP Cos to the DEMPE of intangible assets under the CCA.

[11] A cost contribution arrangement is a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create direct benefits for the businesses of each of the participants, as defined at paragraph 8.3 of Cost Contribution Arrangements - Revisions to Chapter VIII of the Transfer Pricing Guidelines (OECD, 2015, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris). See also section 815-135 of the ITAA 1997 and footnote 1 of this Alert regarding potential amendments to subsection 815-135 of the ITAA 1997.

The expected benefits received by AusCo under the CCA Agreement do not reflect the value of AusCo's contributions to the CCA including the extent or character of functions performed, assets used and risks assumed by AusCo in connection with the intangible assets covered by the CCA. AusCo's proportionate share of overall contributions to the CCA is not consistent with the expected benefits received. Specifically, AusCo does not obtain benefits proportionate with its contributions to the derivation of global income from the exploitation of the intangible assets covered by the CCA, where those intangible assets are used and exploited by ForCo and the IRP Cos in other jurisdictions.

In these circumstances, AusCo's entry into the CCA Agreement may not be commercially rational or consistent with its best economic interests having regard to the commercial options realistically available. The arrangement may therefore be inconsistent with that which might reasonably be expected to be agreed between independent parties dealing at arm's length for the purposes of Australia's transfer pricing laws. Additionally, in such circumstances the arrangement may have been entered into for the sole, dominant or principal purpose, or for more than one principal purpose that includes a purpose of obtaining a tax benefit or DPT tax benefit[12], within the meaning of Australia's GAAR and DPT provisions.

Arrangement 2 – example 2



An Australian company (AusCo) is party to an arrangement with a related foreign company (ForCo) which provides that AusCo:

- *pays royalties to ForCo for the use of patents, trade marks and know-how stored in an online database (Intangibles)*
- *is obliged to record in the database all know-how developed and obtained by AusCo in the course of its Australian operations including all commercial, scientific and industrial information and data*
- *performs contract R&D services for, or on behalf of, ForCo and is remunerated on a cost plus basis.*

Under the arrangement the Intangibles are stated to be principally developed, enhanced, maintained and protected by ForCo. ForCo is said to derive income from the global exploitation of the Intangibles.

AusCo has material business operations and employs specialised staff. AusCo uses the Intangibles in its Australian operations and records and stores in the database all

[12] Or both to obtain a tax benefit and to reduce one or more of the parties' liabilities to tax under a foreign law, see Part IVA of the ITAA 1936.

know-how including know-how developed in the course of AusCo's operations for a number of significant Australian projects.

AusCo performs DEMPE activities and assumes associated risks as part of the R&D activities said to be performed on behalf of ForCo including developing and commercialising new know-how, patents and like assets. AusCo performs these functions, uses assets and assumes risks with minimal direction and oversight from ForCo. The income derived by ForCo from the global exploitation of the Intangibles, and the value of the Intangibles, increases as a result of the DEMPE activities performed by AusCo.

ForCo does not have substantial business operations and it employs a limited number of suitably qualified staff. AusCo frequently performs the R&D and commercialisation activities said to be performed on behalf of, or at the request of, ForCo. ForCo does not possess sufficient assets or employ sufficient suitably qualified staff to primarily manage, perform and control the DEMPE of the Intangibles.

AusCo's remuneration under the arrangement with ForCo does not reflect the extent or character of functions performed, assets used and risks assumed by AusCo in connection with the arrangement. In these circumstances, the conditions operating in connection with the arrangement may not be consistent with arm's length conditions for the purposes of Australia's transfer pricing laws.

AusCo's entry into the arrangement may not be commercially rational or consistent with its best economic interests having regard to the commercial options realistically available. The arrangement may therefore be inconsistent with that which might reasonably be expected to be agreed between independent parties dealing at arm's length for the purposes of Australia's transfer pricing laws. Additionally, in such circumstances the arrangement may have been entered into for the sole, dominant or principal purpose, or for more than one principal purpose that includes a purpose of obtaining a tax benefit or DPT tax benefit[13], within the meaning of Australia's GAAR and DPT provisions.

What are our concerns?

We are concerned that arrangements of the type considered in this Alert are not arm's length for the purposes of determining if an entity obtained a transfer pricing benefit[14] under Australia's transfer pricing laws, having regard to the functions performed, assets used and risks assumed by Australian entities. In these circumstances, Division 815 of the ITAA 1997 may apply.

We are also concerned that these arrangements may fail to properly comply with Australian CGT and capital allowances laws where intangible assets, which are CGT assets or depreciating assets, have migrated as a result of the arrangement.[15] The CGT or capital allowances provisions may apply where an entity acquires, creates, disposes of, recognises, loses, or surrenders intangible assets and/or associated rights. In these circumstances, Part 3-1, Part 3-3 or Division 40 of the ITAA 1997 may apply.

We are also concerned that arrangements of the type considered in this Taxpayer Alert may be entered into or carried out for the sole, dominant or principal purpose, or for more

[13] Or both to obtain a tax benefit and to reduce one or more of the parties' liabilities to tax under a foreign law, see Part IVA of the ITAA 1936.
[14] As defined in section 815-120 of the ITAA 1997.
[15] As outlined in Part 3-1, Part 3-3 and Division 40 of the ITAA 1997. It is noted that Division 40 of the ITAA 1997 applies to items of intellectual property including patents, registered designs, copyright and associated rights as identified in the definition of 'intellectual property' provided in subsection 995-1(1) of the ITAA 1997, see subsection 40-30(2) of the ITAA 1997.

than one principal purpose that includes a purpose of obtaining a tax benefit or DPT tax benefit. This may attract the application of the GAAR[16] or the DPT provisions.[17]

What are we doing?

We are currently reviewing these arrangements and engaging with taxpayers who have entered into, or are considering entering into, these arrangements. Our engagement and assurance activities will continue as we develop our technical position on these arrangements.

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

What should you do?

If you have entered into, or are contemplating entering into, an arrangement of this type we encourage you to discuss your situation with us by emailing **PGIIntangiblesMigration@ato.gov.au**.

Penalties may apply to participants in and promoters of this type of arrangement.

Contact officer: **Christopher Ferguson**

Email address: **PGIIntangiblesMigration@ato.gov.au**

Commissioner of Taxation
22 January 2020

[16] As outlined in Part IVA of the ITAA 1936.
[17] As outlined in Part IVA of the ITAA 1936. Further information concerning the application of the DPT to cross border arrangements in connection with intangible assets is available in PCG 2018/5 and LCR 2018/6.

References

ATOlaw topics	International issues ~~ Transfer pricing ~~ Documentation International issues ~~ Transfer pricing ~~ Profit shifting Tax integrity measures ~~ Part IVA ~~ General anti-avoidance rules International issues ~~ Tax havens ~~ Profit shifting International issues ~~ Foreign income ~~ Royalties International issues ~~ Non-resident Australian income ~~ Royalties Income tax ~~ Assessable income ~~ Royalty income ~~ Royalty income Income tax ~~ Assessable income ~~ Royalty income ~~ Royalties paid to non resident Income tax ~~ Capital allowances ~~ Depreciation ~~ Balancing adjustment issues Income tax ~~ Capital gains tax ~~ CGT Events ~~ General Income tax ~~ Capital gains tax ~~ CGT Events ~~ CGT event A1 - disposal of a CGT asset
Legislative references	ITAA 1936 Pt IVA ITAA 1997 Pt 3-1 ITAA 1997 Pt 3-3 ITAA 1997 Div 40 ITAA 1997 40-30(2) ITAA 1997 815-120 ITAA 1997 815-130 ITAA 1997 815-130(2) ITAA 1997 815-130(3) ITAA 1997 815-130(4) ITAA 1997 Div 815 ITAA 1997 815-135 ITAA 1997 815-135(2)(a) ITAA 1997 815-135(2)(aa) ITAA 1997 995-1(1)
Other references	OECD, 2015, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris OECD, 2017, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing, Paris Treasury consultation, Miscellaneous amendments to Treasury Portfolio laws PCG 2018/5
Related practice statements	PS LA 2005/24
Related rulings	TR 2004/1 LCR 2018/6
Authorised by	Rebecca Saint, Deputy Commissioner