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Tax Alert

Australian Taxation Office issues compliance guidelines on Intangible Arrangements

At a glance

- The PCG increases the analysis and documentation expected by the ATO for intangible arrangements
- Taxpayers should carefully review their Intangible Arrangements and supporting documentation
- The PCG does not go further and address issues in relation to how Intangible Arrangements should be remunerated, priced or benchmarked
- How EY can help

On 19 May 2021, the Australian Taxation Office (ATO) released guidance on Intangible Arrangements with international related parties in the draft Practical Compliance Guideline (PCG) 2021/D4. This represents the latest of the ATO's transfer pricing-focused PCGs.

The PCG (link) outlines the ATO's compliance approach and risk factors connected with 'Intangibles Arrangements', encompassing arrangements connected with the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangible assets or where intangible assets are migrated offshore. The definition of intangible assets and the DEMPE framework are sourced from the OECD Transfer Pricing Guidelines.

Similar to the other transfer pricing focused PCGs, the ATOs risk assessment framework identifies three risk categories (i.e. low, medium and high risk) for Intangible Arrangements based on various risk factors and the level of supporting evidence prepared. These factors include:

- Understanding and evidencing the commercial considerations and your decision making, where you have restructured or had a change associated with your Intangibles Arrangements
- Understanding the form of your Intangibles Arrangements
- Identifying and evidencing the intangible assets and connected DEMPE activities of your Intangibles Arrangements
- Analysing the tax and profit outcomes of your Intangibles Arrangements
- Assessment of the Intangible Arrangements against the examples contained within Appendix 2 of this Guideline

A key requirement of the PCG, is the increased analysis and supporting evidence expected by the ATO when analysing Intangible Arrangements. In this regard, the PCG outlines exhaustive supplementary documents that may be required during a review to identify the benefits of any Intangible Arrangement, the nature of intangible assets utilised, the commercial considerations associated with the arrangement, the DEMPE activities and the profit outcomes between the parties.

Despite the guidance provided in relation to documentation, the PCG does not go further and address issues in relation to how Intangible Arrangements should be remunerated, priced or benchmarked. Given this omission, the PCG notes that "exhibiting Medium or Low Risk Factors may not exclude your Intangibles Arrangements from further review".

It is expected that once the PCG is finalised, taxpayers will be required to complete a Reportable Tax Position (RTP) to disclose the risk rating for their Intangible Arrangements.

Compliance Approach

The PCG confirms that the ATO will review Intangible Arrangements with a focus on identifying arrangements that mischaracterise Australian DEMPE activities. In particular, the ATO is concerned whether the functions performed by Australian entities (in connection with the DEMPE of intangible assets) are properly recognised and remunerated in accordance with the arm's length principle embodied in Australia's transfer pricing rules.

The PCG is aimed at achieving compliance with each step of the Australian legislation as well as consistency with the relevant transfer pricing guidelines (i.e. Chapter I, VI and IX of the 2017 OECD Guidelines). On this basis, consistent with the obligations of Subdivision 815-B, the PCG guides taxpayers to first assess whether the 'actual conditions' of the Intangible Arrangement are consistent with the 'arm's length conditions'. In the event they are different, there may be a requirement to substitute the arm's length conditions.

Consistent with other transfer pricing PCGs, the level of engagement (or likely ATO review) will be dependent on the risk assessment of the Intangible Arrangement. In this regard, if an Intangible Arrangement exhibits one or more of the High-Risk Factors (as described below), the ATO will likely commence further engagement which may include a review or audit.

The PCG does highlight that the advance pricing arrangement (APA) program can provide taxpayers with certainty on their Intangible Arrangements. However, to be accepted into the APA program, the ATO will expect that the documentation and evidence prepared is consistent with the requirements of this PCG. Further it is indicated that a taxpayer will be more likely to be invited to make a formal APA application where the Intangibles Arrangements exhibit the Low Risk Factors.

Risk Factors

The PCG outlines four risk factors and twelve examples that form the basis of ATOs risk assessment. The four risk factors are summarised below.

Evidence of the commercial considerations and decision making

In circumstances where you have restructured or had a change of arrangement, there is an expectation that the taxpayer analyses and documents the circumstances in which the restructure was entered into or occurred.

Evidence to support this position should be contemporaneous and verify the market value of any intangibles acquired (or sold), identify the tax and commercial objectives considered and any other considerations. The evidence and documents potentially required by the ATO is exhaustive and includes:

- Internal or independent reviews, cost-benefit analyses, forecasts, projections, modelling or advice obtained in relation to your arrangements
- Documents created by tax advisers disclosing anticipated or potential Australian tax effects including financial models, slides or step plans
- Briefing materials, analysis and data by or for internal and independent specialists
- Presentations or papers provided to the taxpayer's management team, board of directors, etc.
- Board minutes and records of other meetings at which all Intangibles Arrangements, including alternative arrangements not pursued, were discussed
- Commercial, regulatory and tax advice obtained in connection with your Intangibles Arrangements
- Details of any changes to the transfer pricing policy including the rationale for any such changes
- Details of any changes to inter-company agreements and company policies in the relevant period

Understanding the form of your Intangible Arrangement

The form of your arrangement should be substantiated by documents, such as legal agreements, internal guidelines, manuals, policies, procedures and governance documents. These documents could include:

- Legal agreements and memoranda, including any amendments or restatements to such documents
- Details of ownership of intangible assets including whether ownership rights may have been diluted
- Planning details associated with the set-up of the legal arrangements
- Guidelines, manuals, policies, procedures, specifications and like documents developed and/or maintained
- Transfer pricing documentation, including any supplementary analysis or valuation associated with the Intangibles Arrangement

Identifying intangible assets and connected DEMPE activities

The documentation should accurately identify the nature of the intangible assets, the DEMPE activities and evidence the entities that manage, perform and control DEMPE activities. The supporting evidence may include:

- Intangible asset registers and AASB Standard 138-compliant financial statements
- Registration documents, such as those required by and produced for IP Australia
- Internal or external database extracts

- Reports, specifications or R&D stage-gate documents
- Guidelines, manuals, policies, procedures and like documents relevant to identifying the relevant intangible assets

Analysing the tax and profit outcomes of your Intangibles Arrangement

Documentation should substantiate the economic outcomes and benefits obtained by relevant entities which align with the DEMPE activities and the functions performed. In considering whether the tax and profit outcomes are consistent with the commercial and economic substance, the evidence assessed may include:

- Comparability studies, valuations or projections
- Financial modelling and underlying materials associated with projections or anticipated tax impacts
- Evidence of actual cash flows
- Financial, transactional and tax information for relevant domestic and offshore entities

Intangible Arrangement Examples

Appendix 2 provides twelve examples of Intangible Arrangements and their risk assessment under the PCG framework (i.e. High, Medium or Low risk). The PCG is therefore 'example heavy', but the focus of the examples perhaps provides some insight into the ATO's areas of concern. Whilst the inclusion of examples is welcomed, the risk assessment for these examples is heavily impacted by a 'statement of fact' on whether the documentation prepared was either not maintained (i.e. High Risk), incomplete (i.e. Medium Risk) or substantiates the arm's length nature of the arrangement (i.e. Low Risk). As such, it raises the question as to the extent to which these examples provide practical guidance on the nature, quantum or type of analysis required to differentiate between a Low and Medium Risk assessment.

Reportable Tax Positions

As noted, the PCG anticipates companies required to lodge an RTP Schedule with their corporate income tax return may be required to disclose:

- How the Intangibles Arrangement compares to each of the Risk Factors and whether they can be described as High, Medium or Low risk
- How the Intangible Arrangement compares to the examples contained within Appendix 2 and whether they can be described as High, Medium or Low risk
- That you chose not to, or could not, self-assess your risk

As highlighted above, if the RTP discloses one or more of these High-Risk Factors, the ATO will be likely to undertake further engagement with taxpayers, which may include a review or audit.

Conclusion

Our key takeaways from the release of the PCG are:

- The release of the PCG indicates that Intangible Arrangements will remain a key area of focus for the ATO in the near future.
- Any taxpayer with an RTP lodgement obligation should review their arrangements against the risk factors and the included examples. In particular, any company that exhibits one (or more) risk factors may need to anticipate having their arrangements reviewed by the ATO.
- The guidance contemplates comprehensive analysis and documentation as necessary to demonstrate a 'low risk' Intangibles Arrangement, although guidance on the 'shape and form' of this documentation is limited.
- It is reasonable to assume that the ATO's expectations of the comprehensiveness of documentation is beyond what may historically have been prepared which will particularly place pressure on taxpayers that may need to make decisions regarding Intangibles Arrangements urgently. The PCG also does not factor in the fact that different businesses will be likely to have different decision making processes and evidence (e.g. a large public company versus an entrepreneurial business).
- The guidance does not provide taxpayers with additional guidance on how Intangible Arrangements should be remunerated, benchmarked or what an acceptable transfer pricing methodology may be. Among other things, to assist taxpayers, there remains an ongoing need for the possibility of positive early engagement with the ATO on complex Intangible Arrangements cases (including APA program engagement). The ATO has indicated that it encourages this type of engagement
- The ATO's guidance is now more detailed (which is welcomed) but presents practical application challenges.

How EY can help

EY has been, and continues to be, involved in ongoing consultation with the ATO regarding the scope and details of the PCG.

In this regard, the ATO continues to encourage taxpayers to proactively engage with them to address specific issues.

EY will work closely with taxpayers in these discussions in order to raise issues and help to achieve an increase in clarity of the ATO's expectations. We welcome your input as part of this process.

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