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# Tax Alert

## ATO Taxpayer Alert 2023/5 - Research and development activities conducted overseas for foreign related entities

### At a glance

- TA 2023/5 highlights risks with research and development (R&D) activities ultimately conducted for foreign affiliated entity(s).
- Affected taxpayers broadly include inbound life science companies that were incorporated by a foreign parent to undertake clinical trials.
- R&D tax incentive offsets may have been incorrectly claimed as Australian-owned under Australian R&D tax law, when in fact the R&D activities were conducted to a significant extent for the foreign affiliated entity(s).
- The ATO is currently reviewing these arrangements in the context of risk factors highlighted in this Taxpayer Alert.

In December 2023, the Australian Taxation Office (ATO) released a Taxpayer Alert (TA 2023/5) in relation to research and development (R&D) activities conducted by Australian R&D entities for foreign related entities. This represents the latest of the ATO's guidance which highlights the need to review arrangements involving intangible property (IP) and to consider the economic substance of arrangements in place as opposed to solely the legal form.

TA 2023/5 (link) outlines common features of arrangements in which R&D activities are conducted for foreign related entities, and the ATO's concern that the R&D tax offset may be being incorrectly characterized. These arrangements may involve inbound R&D entities in the life science industry that were incorporated by a foreign parent to undertake clinical trials in Australia.

With these arrangements, Australian R&D entities may have incorrectly claimed a refundable or non-refundable tax offset as "Australian-owned R&D" that some would refer to as an entrepreneurial model. The "Australian-owned R&D" rules require the R&D activities to be conducted for the major benefit of the Australian R&D entity itself and not to a significant extent for the foreign parent.

When inbound R&D arrangements have been reviewed by the ATO, certain fact patterns have resulted in the ATO taking the view that in some cases the R&D activities are in fact conducted for the major benefit of an associated foreign corporation as opposed to the Australian R&D entity.

Where there are differences between the economic or commercial substance of the arrangements and their legal form, the ATO's view is that the tax benefit should reflect the actual commercial and economic substance of what actually occurred with the R&D activities carried out in Australia.

The ATO have also stated their concern is irrespective of whether the R&D activities are covered by an advance overseas finding or if the Australian entity retains IP ownership, project results or know-how according to their legal agreements.

This view aligns with the ATO's latest guidance on intangible arrangements, including contract-based research and development, cost contribution arrangements and licensing, as outlined in their practical compliance guide (PCG) 2024/1.

## Affected taxpayers

Common features of these arrangements include:

- An Australian entity is incorporated for the purpose of conducting R&D activities (generally in the form of clinical trials). The Australian R&D entity is related to the foreign entity (foreign parent).
- The foreign parent finances the Australian R&D entity (and the R&D activities) via funding arrangements that may include equity or debt such as a related-party non-recourse loan.
- The Australian R&D entity has limited assets and minimal or no staff in Australia.
- The background IP on which the Australian R&D is based is owned by the foreign parent.
- The local Australian oversight and management of the clinical trial R&D activities are often entirely outsourced to Contract Research Providers (CROs).
- The Australian R&D entity claims a notional deduction for the expenditure incurred by it to the CRO as "Australian-owned R&D" and receives a tax offset under the R&D tax incentive.
- An advanced overseas finding does not confirm the suitability of the Australian entity structure to claim the Australian-owned R&D tax incentive.

## Risk factors

The key risk factors with these arrangements have been identified as:

- An Australian R&D entity is established by a foreign parent and the foreign parent executes an intercompany agreement which places control and strategic decision making regarding the R&D activities with the foreign parent.
- As part of the intercompany agreement, the foreign parent may grant the Australian R&D entity a license to use existing IP and/or receive primary rights to exploit any intellectual property, know-how or results developed from the IP.
- A functional analysis of day-to-day operations between the two entities would indicate that the control of the R&D activities may sit with the foreign parent not the Australian R&D entity.
- The Australian R&D entity is often financially reliant on the parent entity rather than raising independent capital to fund its business activities in Australia. This raises questions about its financial capacity to bear the ultimate financial risk in relation to the R&D activity.

## Expenditure not "at risk"

Under the Australian-owned R&D tax incentive rules, expenditure that is not "at risk" (e.g., under a guaranteed financing agreement) to the R&D entity, is ineligible under the R&D tax incentive.

Expenditure is not at risk to the extent that when it's incurred, the R&D entity could reasonably be expected to receive an amount of consideration:

- As a direct or indirect result of the expenditure being incurred (the nexus to expenditure test).
- Regardless of the results of the activities on which you incur the expenditure (results test).

The R&D activities undertaken under the arrangements described above are often funded by a related-party non-recourse loan arrangement which is regardless of the outcome of the results of the activities. The ATO examine this fact pattern closely in Example 11 of their taxation ruling (TR) 2021/5 related to the 'at risk' rule.

It is likely that the financing arrangement for the R&D activities under these arrangements would be examined closely by the ATO against the "at-risk" provisions.

## Foreign-owned R&D provisions

Where the R&D activities are conducted to a significant extent for a related foreign entity (i.e., the foreign entity is receiving a major economic or commercial benefit of the arrangement), the Australian R&D entity may still be eligible to claim the R&D tax incentive offsets as "foreign-owned R&D".

Under the "foreign-owned R&D" provisions, the following additional requirements must be met:

- The foreign entity must be connected or affiliated with the Australian R&D entity.
- The foreign entity must be incorporated in a country that has a double tax agreement with Australia.
- The R&D activity in Australia must be conducted in accordance with a written agreement binding only on the R&D entity and each foreign resident, specifying that the R&D activities are to be conducted either: (1) directly by the R&D entity; or (2) indirectly by another entity under an agreement binding on the R&D entity (for example conducting the R&D activity under a subcontract).
- The R&D activity must be conducted solely in Australia.

Under a "foreign-owned R&D" arrangement additional tax and transfer pricing implications must be considered and applied appropriately based on the ATO's latest guidance on intangible arrangements (for example, recognition of a service fee in the Australian R&D entity for contract R&D services performed for the foreign parent).

## Current regulator activity

The ATO are in the process of reviewing and scrutinizing these arrangements in the context of the TA as they are identified.

The ATO's focus includes Australian subsidiaries of foreign life science companies which are claiming refundable R&D tax offsets for incurred clinical trial

expenditure under the "Australian-owned R&D" provisions.

The key concerns of the ATO are that the R&D activities are:

- Not conducted "for" the Australian R&D entity.
- If the R&D activities are conducted "for" the Australian R&D entity, the expenditure incurred might not be 'at risk'.
- If the arrangement was created for the purpose of obtaining a tax offset, the general tax anti-avoidance provisions may apply.

The ATO have published additional guidance on their website (link) to clarify the R&D program integrity rules and have also issued related Taxpayer Alerts.

## What this means for affected companies

A mischaracterization of a company's R&D tax arrangements can have material cash flow implications with respect to its R&D tax offsets.

Companies with arrangements highlighted in this Taxpayer Alert may still be eligible for the foreign-owned R&D tax offsets. However additional R&D eligibility criteria must be met, and the immediate value of these offsets may be significantly reduced due to the application of appropriate remuneration principles based on ATO's guidance for intangibles arrangements.

## Recommendations and actions

Consider the Taxpayer Alert and review R&D arrangements with your tax agent. This should include consideration of contractual and factual arrangements, legal form, and economic substance of the conduct of R&D activities in Australia.

Where risks are identified in line with the Taxpayer Alert, consider engaging with the ATO around these risk areas.

R&D tax refunds may be significantly delayed as the ATO reviews these arrangements.

## How EY can help

We can assist clients with:

- Risk assessment of inbound R&D arrangements and claims
- Recommendations to improve current processes and documentation
- Strategies to manage potential risks identified
- High-level R&D tax incentive claim and income tax return review
- Foreign owned R&D eligibility analysis
- Review of the appropriateness of the R&D expenditure
- Review of relevant contracts or intercompany agreements
- Review or preparation of transfer pricing policies or calculations.

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