



# Tax Alert

## Australian Taxation Office finalises compliance guidelines on intangible arrangements

### At a glance

- ▶ Final ATO guidance now released
- ▶ ATO risk assessment of intangibles transactions
- ▶ Point-scoring system assigns risk ratings
- ▶ Requires significant amount of analysis and supporting evidence for 'in-scope' intangibles arrangements
- ▶ Many taxpayers with typical business structures will be "high risk"
- ▶ How EY can help

On 17 January 2024, the Australian Taxation Office (ATO) released the final guidance on intangible arrangements with international related parties in the Practical Compliance Guideline (PCG) 2024/1, which supersedes the drafts previously released (PCG 2021/D4 and PCG 2023/D2).

This represents the latest of the ATO's transfer pricing-focused PCGs, and it further emphasises the ATO's ongoing focus on cross-border dealings involving intellectual property. Consistent with this compliance focus, there is a strong emphasis on the 'economic substance' of arrangements. The ATO is highlighting again in this PCG that they will not be limited by the 'legal form' of taxpayers' arrangements.

The PCG has potentially wide application across all industry sectors where there are transactions involving IP.

The PCG ([link](#)) outlines the ATO's compliance approach and risk factors connected with 'intangibles migration arrangements', encompassing arrangements connected with the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangible assets or where intangible assets are migrated offshore.

Similar to the other transfer pricing focused PCGs, the ATO's risk assessment framework comprises several risk categories (low, medium and high risk) for Intangible Arrangements based on various risk factors and the existence of legal agreements (in some circumstances).

The major change from PCG 2021/D4, is the presentation of the risk assessment framework into two categories, together with two 'scoring systems' to determine risk ratings.

The two risk assessment framework categories are:

- ▶ Migration of intangible assets
- ▶ Mischaracterisation and non-recognition of Australian activities connected with intangible assets.

A point of heavy emphasis in the PCG is the ATO's expectations of taxpayers regarding a significant amount of analysis and supporting evidence in relation to 'in-scope' intangibles arrangements. The evidence is intended to inform questions regarding the benefits of the arrangement, relevant commercial considerations, DEMPE activities, and profit outcomes between the parties.

The PCG does not address issues in relation to how intangibles arrangements should be remunerated, priced, or benchmarked. It is also made explicit in the PCG that it does not address compliance issues in relation to the Taxpayer Alert (TA) 2018/2, TA 2022/2 or the proposed multinational tax integrity measure (denying deductions for payments relating to intangible assets connected with low corporate tax jurisdictions).

The expectation is that taxpayers will be required to disclose the risk rating for their Intangible Arrangement as part of their Reportable Tax Position (RTP) schedule.

## 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.

Emphasis is placed on the practical DEMPE and motivational risk factors relating to the migration of intangibles from Australia and ongoing intangibles arrangements. In this context the ATO maintains that other measures, such as the General Anti-Avoidance Rules (Part IVA) and Diverted Profits Tax may be considered where an arrangement (or a part of an arrangement) lacks substance or probative evidence of the stated non-tax or commercial rationale.

Consistent with other transfer pricing PCGs, the level of engagement (or likely ATO review) will be dependent on the risk assessment of the intangibles arrangement. If an intangibles arrangement achieves a high-risk rating, the ATO will likely commence further engagement which may include a review or audit.

Where the intangibles arrangement meets the requirements to achieve a low-risk rating, ATO engagement is less likely, but if there is evidence that it has been incorrectly priced, the application of this PCG does not preclude that intangibles arrangement from further ATO compliance activity.

The PCG does highlight that the advance pricing arrangement (APA) program can provide taxpayers with certainty on their intangibles arrangements. However, to be accepted into the APA program, the ATO will have regard to a taxpayer's risk rating in accordance with the risk assessment framework.

## Risk Factors

As noted, the PCG provides a 'point-scoring' system in the two risk assessment frameworks that was first proposed in PCG 2023/D2, albeit with modifications in the finalised PCG. In common with other transfer pricing PCGs, the PCG also includes a 'white zone' (where no risk assessment is required). However, notably there is no reference to existence of an APA qualifying taxpayers for the 'white zone'. Details

regarding the two risk assessment frameworks are set out below.

## Migration of Intangible Assets

Where there is migration of intangible assets to an international related party, the risk assessment framework sets out a point-scoring table having regard to the following factors:

- ▶ The occurrence of a restructure or change associated with Australian owned intangible assets
- ▶ Substance of the Relevant Entity (i.e., the international related party), which pays regard to the other party's ability to perform, manage and control DEMPE functions
- ▶ Tax outcomes of the intangibles arrangement.

It is important to note that, where a current intangibles arrangement relates to or is linked to intangibles that have been previously owned by the taxpayer, the migration table must be completed, regardless of when the migration was.

Several features of the scoring system are noteworthy. For example, newly established or startup entities are automatically assigned a higher risk rating with no economic substance 'carve out'. Similarly, certain tax outcomes (attributable to, for example, an entity's residence in a 'specified jurisdiction'; or the availability of R&D tax offset or overseas tax concessions) automatically attract a higher risk score irrespective of the underlying economic substance in the restructured entity.

A higher risk score is also applicable if the restructure results in a reduction (or might 'reasonably be expected' to result in a reduction) in a taxpayer's taxable income - again irrespective of any consideration of underlying economic substance.

Of particular note is also that deductible amortisation or depreciation of the intangible asset in itself is included as a significant factor in assessing the 'tax outcomes' factor.

Where there is ongoing activity by a taxpayer (that is subject to the second risk assessment framework) in relation to an intangible asset previously migrated to an international related party, a risk assessment also needs to be undertaken under this framework for the historical migration, no matter how long ago the migration occurred.

## Other Intangibles Arrangements

Similarly, a scoring system based on 'risk factors' for other intangibles arrangements.

The point-scoring table has regard to the following factors:

- ▶ The taxpayer's overall characterisation and activities in relation to intangibles
- ▶ Substance of the Relevant Entity (i.e., the international related party), with an emphasis on the other party's ability to perform, manage and control DEMPE functions
- ▶ Tax outcomes of the intangibles arrangement.

A higher risk score is automatically applied to arrangements where DEMPE activities or other activities in connection with the intangibles or enhancing their value including R&D activities, manufacturing and marketing are performed by the Australian taxpayer.

Similar to the 'migration of intangible assets' framework, newly established or startup entities are automatically assigned a higher risk rating without regard for their economic substance.

Aside from the risk assessment frameworks, an intangibles arrangement is to be rated high risk if it exhibits features or characteristics (or has a similar effect to) arrangements described in TA 2020/1.

Where the taxpayer's activities that are subject to this risk assessment framework relate to intangible assets that were previously migrated to an international related party, a risk assessment also needs to be undertaken under the first framework (on migration of intangible assets) with respect to the historical migration.

### **Excluded Arrangements**

The PCG excludes the following types of arrangements from the risk assessment frameworks:

- ▶ Excluded Outbound Distribution Arrangement
- ▶ Excluded Inbound Distribution Arrangement
- ▶ Excluded Low Value Services Arrangement.

The excluded arrangements are generally routine arrangements that the ATO perceives to not give rise to the same kind of transfer pricing risks as other, less routine, arrangements.

It should be noted that the exclusions are highly restrictive. For example, sublicensing activities are not considered excluded distribution arrangements, so the form and substance of software distribution arrangements may warrant close examination by taxpayers in the context of the PCG. In addition, inbound distribution arrangements where the Australian distributor has a right to distribute to territories outside of Australia is also not excluded.

### **PCG Examples**

Appendix 1 to the PCG provides 15 examples, which are substantially carried over from PCG 2023/D2 with some modifications and the addition of amber zone and blue zone examples, and another on out-of-scope service arrangements. The PCG also provides the application and calculation of risk scores under these examples.

### **ATO's Evidence Expectations**

Appendix 2 to the PCG sets out the ATO's expectations relating to evidence and record keeping for intangibles arrangements in order to substantiate risk ratings and the arm's length nature of such arrangements more generally. The ATO's evidence expectations remain substantially the same. While it is noted in the PCG that the intention is not to 'unnecessarily impose burdensome requirements' in relation to evidence, the

ATO's expectations are likely to be onerous for taxpayers.

Specific factors identified include:

- ▶ Evidencing the commercial reasons and decision-making process
- ▶ Evidencing the legal form and substance of intangibles arrangements, including:
  - ▶ Legal agreements
  - ▶ Guidelines, manuals, policies, and governance-like documents
  - ▶ Transfer pricing documentation
  - ▶ Country-by-Country reporting documentation
- ▶ Identifying and evidencing the intangible assets and connected DEMPE activities.
- ▶ Evidencing the tax and profit outcomes of your intangibles arrangements

### **Reportable Tax Positions (RTP)**

As noted, the PCG anticipates companies required to lodge an RTP Schedule with their corporate income tax return may be required to disclose the risk ratings obtained under the risk assessment frameworks in relation to intangibles arrangements in the relevant income year, which will make the risk rating highly visible.

### **Conclusion**

Our key takeaways from the release of the PCG include:

- ▶ The release of the final PCG indicates that intangible arrangements continue as a priority compliance issue for the ATO. As noted, in 2023 the Government also proposed (but has not yet enacted) an integrity measure on denial of deductions relating to intangible assets for Significant Global Entities (SGEs), where payments are made to low tax jurisdictions.
- ▶ There is an emphasis on understanding the location of DEMPE functions in this PCG, with the key risk feature being DEMPE functions occurring in locations different from those where legal and beneficial ownership of the underlying intangible resides.
- ▶ The factors considered in the risk assessment frameworks will likely mean many taxpayers' intangibles arrangements would fall into the high-risk zone even where demonstrably the transfer pricing framework results in an appropriate arm's length outcome.
- ▶ The guidance contemplates comprehensive analysis and documentation as necessary to demonstrate a 'low risk' intangibles arrangement. In particular, information on the international related party's tax profile, including eligibility for any credits, offsets or concessions, will be required.
- ▶ 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 are 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 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.
- ▶ Taxpayers would be well-advised to review their intangibles arrangements, assess their risk level under the PCG and, where relevant, proactively gather evidence and documentation to support the arrangements upon review.

#### **How EY can help**

- ▶ EY can assist you to analyse the revised PCG and to develop necessary internal policies and processes in response.
- ▶ We can assist with your engagement with the ATO on specific issues.
- ▶ EY also has extensive experience in assisting taxpayers with their IP migration and intangibles arrangements, including assisting with documentation, proactive ATO engagement and defending the arrangements under review.

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