THE TAX INSTITUTE

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Mr Andrew Orme
Deputy Chief Tax Counsel
Public Advice and Guidance – Tax Counsel Network
Australian Taxation Office
GPO Box 9990
MELBOURNE VIC 3001

By email: andrew.orme@ato.gov.au

Dear Andrew,

JobKeeper guidance on specific issues – transfer pricing / R&D Tax Concession

The Tax Institute would like to make a submission to the Australian Taxation Office (**ATO**) about guidance which has been issued with respect to specific issues and the JobKeeper scheme. Those specific issues are transfer pricing and the R&D Tax concession.

Summary

In summary, our view is that a more considered approach should be taken in relation to guidance being issued on the JobKeeper scheme in relation to transfer pricing and the R&D Tax Concession.

Given the complexity of the topic, we submit that it would be more appropriate for the guidance material to be in the form of a tax determination (**TD**), taxation ruling (**TR**) or practical compliance guideline (**PCG**) where the relevant legal issues can be comprehensively analysed. Comprehensive guidance material in the form of a TD, TR or PCG could be created and referenced in the less technical guidance material currently on the ATO website.

Further, in our opinion, the guidance should give due consideration to the underlying policy objectives of the JobKeeper scheme.

To achieve these objectives, we consider that it would be beneficial for the ATO to consult with the relevant stakeholders prior to issuing further JobKeeper related guidance particularly in relation to transfer pricing and the R&D Tax Concession. We acknowledge the impact of COVID-19 and the immense pressure to release guidance material in short timeframes. However, we maintain that even a brief consultation period with the relevant stakeholders could have improved the quality of the guidance material discussed below.

We discuss each specific issue in more detail below.

Level 37, 100 Miller Street
North Sydney NSW 2060
Tel: 02 8223 0000
Fax: 02 8223 0077
info@taxinstitute.com.au
taxinstitute.com.au
ABN 45 008 392 372

Discussion

1. Specific comments on the 'Transfer Pricing arrangements and JobKeeper Payments' website[1] guidance

We have a number of concerns with the ATO's website guidance, including:

- The Transfer Pricing website guidance does not mention that the accounting treatment of JobKeeper payments for many entities is governed by AASB 120 (*Accounting for Government Grants and Disclosure of Government Assistance*). Under paragraph 29 of AASB 120 (and with a focus on the examples discussed in the ATO guidance), entities have a choice as to how they report government grants related to income: either as income or by deducting the government grant from the related expense.
- Based on the examples contained in the ATO's guidance, it appears that the ATO effectively considers taxpayers who choose to account for JobKeeper payments by deducting the government grant from the related expense (Example 2) to have engaged in non-arm's length behaviour and therefore subject to the transfer pricing rules. In effect, the ATO's guidance appears to deprive entities of the choice they have under the applicable accounting standard. Such an approach has wider implications than just transfer pricing.
- The ATO's guidance expresses the view that 'Independent parties acting in a commercially rational manner would not be expected to share the benefit of the government assistance'. However, it does not consider how the transfer pricing rules in Subdivision 815-B of the *Income Tax Assessment Act 1997* (Cth) would apply in order for such an outcome to arise. For example:
    - The ATO's guidance does not question whether the legal arrangements between the related parties have been amended due to COVID-19 or are not being followed by the parties. On the contrary, it appears to consider that the arrangements between the related parties continue unchanged and further that pre-COVID-19 such arrangements were considered to be arm's length; and
    - The ATO's analysis has not considered what might need to be taken into account for purposes of identifying the arm's length conditions. In this respect, it would be relevant to consider that an independent entity in comparable circumstances to the taxpayer in Example 2 would still have the choice under AASB 120 as to how to account for any JobKeeper payments.

We consider that the issues raised above should be comprehensively analysed. Given the complexity of the topic, we submit that it would be more appropriate for the guidance material on this topic to be in the form of a TD, TR or PCG where the relevant legal issues can be comprehensively analysed. Comprehensive guidance material in the form of a TD, TR or PCG could be created and referenced in the less technical guidance material currently on the ATO website.

For example, the ATO conclusion that 'Independent parties acting in a commercially rational manner would not be expected to share the benefit of the government assistance' should have been comprehensively analysed having regard to the relevant statutory provisions to justify the conclusion. Further, this conclusion should have been compared and reconciled with the view expressed in TD 2002/20 (ie that government

[1] https://www.ato.gov.au/Business/International-tax-for-business/In-detail/Transfer-pricing/Transfer-pricing-arrangements-and-JobKeeper-payments/

assistance in the form of the "tax offset scheme should be treated as a condition of the market for film production services in Australia, and taken into account in evaluating a taxpayer's transfer price in that market").[2] Such analysis would be more appropriate in a TD, TR or PCG.

The view expressed in TD 2002/20 is supported by TR 97/20[3] and the OECD's Transfer Pricing Guidelines. More generally, TD 2002/20 recognised that the tax offset scheme might potentially have a number of differing market impacts. In stark contrast, the ATO's website guidance expresses a 'correct transfer pricing treatment' view and an 'incorrect transfer pricing treatment' view and provides no support for the ATO's preferred view. In forming this view, the ATO guidance should have included the reasoning supporting its position and explained the difference in the approach taken in other ATO guidance material.

As stated above, given the complexity of this issue, we consider that it would be more appropriate for the guidance on this topic to be in the form of a TD, TR or PCG where the relevant legal issues can be comprehensively analysed.

A key assumption underpinning the ATO's guidance is that 'The Australian subsidiary is eligible for and receives the JobKeeper payments'. However, to be eligible for JobKeeper payments, in broad terms, the taxpayer needs to have suffered a 30% fall in turnover measured over a 12 month with turnover being calculated based on GST turnover. Based on the examples provided in the ATO's guidance:

- The taxpayer could not have been eligible for JobKeeper payments to begin with because of the transfer pricing methodology used (ie the method is a cost-based method and all other things being equal its turnover will not have fallen due to COVID-19 because its remuneration/turnover is based on its costs) - in which case the assumption underpinning the example has no validity; or
- The taxpayer could dismiss at least 50% of its workforce in order to achieve the necessary 30% reduction in its turnover (although this gives rise to the obvious question as to why it would do this), receive JobKeeper payments, reinstate its previously dismissed employees, and end up in the situation where it is no longer eligible for JobKeeper payments because its turnover has not now fallen by 30% due to the cost-based transfer pricing methodology used. Again, the assumption underpinning the example is not valid in the context of the actual example.

Notwithstanding the above, the ATO's guidance states that 'The following is a basic example of how JobKeeper payments <u>should be treated</u> in transfer pricing arrangements'. We consider that such a statement approximates interpretative guidance and as such would be better contained in a ruling or determination rather than as a statement on the ATO's website. In our view, this provides a further example of the concerns raised in Section 3 of our submission to you of 14 November 2019 in relation to ATO Guidance.

We understand why the ATO is looking at such arrangements. However, the issue arises because of how the transfer pricing methodology used (a cost-based methodology) interplays with the accounting standards and the choices entities may be given under them.

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[2] Paragraph 4 of *Taxation Determination TD 2002/20 Income Tax: Income tax: If an Australian film production company alters its method of charging for film production services supplied to a foreign associate to account for the impact of the tax offset scheme under Division 376 of the Income Tax Assessment Act 1997, will the Commissioner apply Division 13 of Part III of the Income Tax Assessment Act 1936 or the Associated Enterprises article of a relevant double tax agreement to increase the charge?*

[3] *Taxation Ruling TR 97/20 Income Tax: Arm's length transfer pricing methodologies for international dealings*

From a big picture perspective, we consider that the view taken in this guidance also runs counter to the JobKeeper policy intent which is to encourage employers to retain employees on their payroll and consequently for employees to stay connected with their employers.

We consider that this guidance would have benefited from external consultation prior to its publication as the issues we have now raised could have been addressed prior to finalising the guidance. We recognise that COVID-19 has put extraordinary pressure on all parties. This includes the ATO which has been required to provide guidance and administer many new initiatives that have been introduced quickly to mitigate the impact of COVID-19. However, we maintain that even a brief consultation period with the relevant stakeholders could have improved the quality of the guidance material discussed above.

We request the ATO to reconsider its 'Transfer Pricing arrangements and JobKeeper Payments' website guidance in light of the above concerns. In the interim, we consider that taxpayers should be permitted to take a 'reasonable approach' and follow the accounting standards as intended.

2. R&D Tax Incentive – draft TD 2020/D1

We refer to *Draft Tax Determination TD 2020/D1 Income tax: notional deductions for research and development activities subsidised by JobKeeper payments* (**TD 2020/D1**). Our understanding of the way the TD 2020/D1 has been prepared is that eligibility for the notional deduction under the research and development (R&D) tax incentive turns on whether the JobKeeper subsidy is regarded as consideration received directly or indirectly as a result of paying wages to an eligible employee undertaking eligible R&D activities or not. TD 2020/D1 would prevent a taxpayer from being eligible for a notional deduction under the R&D tax incentive rules because it considers JobKeeper scheme payments to be consideration received directly or indirectly by the taxpayer as a result of paying wages to eligible employees undertaking eligible R&D activities such that the at-risk rule in section 355-405 applies.

We do not agree with this view. The eligible employees were engaged by the taxpayer to perform at-risk R&D activities. They were not engaged by the taxpayer for purposes of being eligible to obtain JobKeeper payments. In our view, a taxpayer that is otherwise eligible for a notional deduction for the cost of employees engaging in R&D activity should not be denied that deduction because the funding for the employees is supplemented by the JobKeeper scheme.

We also consider that the view expressed in TD 2020/D1 runs counter to the policy intent underlying the R&D tax incentive which is to encourage employers to undertake eligible R&D activities. Once an employee has been engaged, whether wholly or partly funded by JobKeeper, the employer may choose what work that employee is asked to undertake. If the employer chooses for that employee to undertake R&D, as is encouraged by the R&D tax incentive, then the employer should be entitled to the benefit of the R&D tax incentive. Alternatively, if the employer chooses for that employee to undertake 'business as usual' non-R&D work, then the employer will only be entitled to the ordinary deduction. It is the choice of what work is done by the employee which determines whether the R&D tax incentive is available.

This guidance would have benefited from external stakeholder consultation prior to being issued in draft for comment. We are aware of the time pressures faced by the ATO in relation to releasing guidance in response to JobKeeper and other issues arising as a result of COVID-19. However, we consider that even limited consultation with key stakeholders could have addressed the issues raised above.

If you would like to discuss any of the above, please contact either myself or Tax Counsel, Angie Ananda on 02 8223 0000.

Yours faithfully,

Peter Godber
President