THE TAX INSTITUTE

16 July 2021

Christopher Ferguson

Assistant Commissioner, Public Groups and International

Australian Taxation Office

By email: IntangiblesArrangements@ato.gov.au

Dear Christopher,

Draft Practical Compliance Guideline PCG 2021/D4 — Intangibles Arrangements

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to the draft Practical Compliance Guideline PCG 2021/D4, *Intangibles Arrangements* (**Draft PCG**).

This submission has been developed in close consultation with a subcommittee of The Tax Institute's members to obtain a breadth of views on issues that impact our broader membership.

We invite the ATO to consider our submission and respectfully request that further action as recommended in this submission is taken to enhance the Draft PCG to ensure clear guidance and practical insight is provided to the community. We have set out below our main concerns in relation to the Draft PCG, in particular:

- the object and purpose of the Draft PCG, and the extent to which it goes beyond existing guidance relating to transfer pricing; and
- the onerous documentation and evidence requirements currently required under the Draft PCG, including those requirements having retrospective effect.

Our detailed submission is contained in **Appendix A**.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all. Please refer to **Appendix B** for more about The Tax Institute.

If you would like to discuss any of the above, please contact either myself or Tax Counsel, Julie Abdalla, on (02) 8223 0058.

Yours faithfully,

Jerome Tse

Vice President

APPENDIX A

Purpose of the Draft PCG

We consider it would be beneficial if there was a clearer statement of purpose as to why compliance guidance is being published in relation to "Intangibles Arrangements" as a specific, standalone concept. This is recommended because of the broad definition of Intangibles Arrangements being adopted in the Draft PCG and the potential overlap of some of the requirements set out in TR 2014/8 *Income tax: transfer pricing documentation and Subdivision 284-E*.

Paragraph 1 of the Draft PCG defines Intangibles Arrangements as:

> "*international arrangements connected with the development, enhancement, maintenance, protection and exploitation (**DEMPE**) of intangible assets and/or involving a migration of intangible assets. A 'migration' refers to any transaction or transactions that allows an offshore party to access, hold, use, transfer, or obtain benefits in connection with intangible assets and/or associated rights.*"

This is a wide definition which is consistent with the Organisation for Economic Co-operation and Development's (**OECD**) definition of intangible assets as set out in the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (**OECD Transfer Pricing Guidelines**). It also applies the transfer pricing concept of DEMPE. In its terms, however, the Draft PCG focuses on the tax risks associated with a wide range of contexts beyond transfer pricing, and expressly states that its focus is on:

> *"tax risks associated with the potential application of the transfer pricing provisions … [and] … other tax risks that may be associated with Intangibles Arrangements, specifically the withholding tax provisions, capital gains tax (CGT), capital allowances, the general anti-avoidance rule (GAAR), and the diverted profits tax (DPT)"* (see paragraph 2).

We understand anecdotally, that the Draft PCG is intended to extend beyond transfer pricing risks. For this reason, The Tax Institute considers that it would be beneficial if there were a clearer statement of this Draft PCG's object and purpose, including how the Draft PCG should be read alongside existing ATO guidance.

Scope of the Draft PCG

Related to the above comments on the Draft PCG's object and purpose, The Tax Institute is of the view that the scope of the Draft PCG is unnecessarily broad. The Draft PCG relies in large part on transfer pricing concepts, while stating that it will apply more broadly to tax risks beyond those associated with Australia's transfer pricing regime. Further, the Draft PCG's broad documentation requirements go beyond what is required by the OECD Transfer Pricing Guidelines.

The Tax Institute considers that there are two overarching factors that could reduce the unnecessarily broad scoping of the Draft PCG.

The first is resetting the specific examples of concern to instead be 'gateway' categories of concern, with the underpinning issue being that there is a demonstrable risk that a transfer pricing (or other tax) benefit has arisen. This would align the Draft PCG more closely with what we understand to be the ATO's actual concerns. In this respect it would be more specific to each inherent tax concern (i.e. withholding tax, diverted profits tax, transfer pricing etc). Notionally, these categories would appear to be:

1. non-recognition of value and tax in Australia in relation to the migration of intangible assets offshore through:
    a. centralisation or bifurcation;
    b. non-recognition of pre-commercialised development; and
    c. the transfer of rights under licensing agreements, and
2. non-recognition of income in Australia attached to DEMPE functions in relation to international arrangements involving intangibles through lower value rewards for Australian entities under:

a. contract R&D arrangements;

b. cost contribution arrangements; and

c. non-identification of new technology/innovations.

The second more explicitly aligns the requirements of the Draft PCG with the areas of concern and analysis as set out in Chapter VI (and by proxy, or including Chapters I and IX) of the OECD Transfer Pricing Guidelines. This could include recognising that there is naturally a spectrum of risk that needs to be observed so that not all arrangements attract the same level of analysis/evidence gathering. This should specifically take account of the following:

1. Certain intangibles have no value separable from a transaction (for example, "know how" in the context of services) and are therefore already priced appropriately (for example, as a service charge), meaning there is a lower risk of any transfer pricing benefit being attained. It would seem onerous to require taxpayers to keep detailed documentation in respect of, or allocate resources to, identify and further assess such intangibles. Know-how is considered further below.

2. Following the functional analysis and identification of intangibles, risks etc., the economic analysis or benchmarking elements of a transfer pricing analysis are generally predicated on looking to the simplest part of the transaction to make the arm's length determination (in terms of an actual price). Analysing all intangibles in an operating business in accordance with the Draft PCG, where those intangibles are used solely in that business (and are not realistically transferable), and are not relevant to a particular transaction, creates a significant compliance burden for no real tax risk-mitigation benefit.

   Using a simple example, one could consider the provision of a service from entities in Country A and Country B into an entity in Country C which manufactures, markets and sells goods, and exploits valuable intangible assets in undertaking its operations in Country C. Normally in such circumstances, for transfer pricing purposes, the taxpayer would undertake all the relevant analyses and then focus on pricing the service provision to the entity in Country C (in that sense the manufacturer in Country C sits as the residual profit taker).

   The taxpayers would not then go back and perform a DEMPE analysis on anything beyond how that service provision were to be split between the entities in Country A and Country B. If, for example, there were a unique process that drives value in the service provision, and the taxpayer had to then recognise the DEMPE functionality relative to that and the reward for services across the entities in Country A and B, the total reward may be (for illustrative purposes) cost plus 20% as a charge to the entity in Country C, but the split between the entities in Country A and Country B may be cost plus 5% and cost plus 15% based on DEMPE contributions (assuming the process drove much of the value). The taxpayer would not split the profits or losses left in the entity in Country C beyond that.

   However, the Draft PCG requires full documentation relative to any intangible forming part of that transaction, including the subsequent DEMPE analysis, and so departs from how taxpayers would ordinarily approach such a transaction. Whereas a taxpayer in these circumstances would normally identify the valuable intangible assets as an intangible for the entity in Country C, and even though the reward for the entity in Country C is not something that normally would be priced, the taxpayer would be required to produce DEMPE documentation or would be in the Draft PCG's high risk zone.

3. It would create an unnecessary and significant burden on taxpayers to document and provide a full DEMPE analysis for every Intangibles Arrangement identified. This is because not all intangibles will generate non-routine returns (and so there would not necessarily be residual returns to split amongst the DEMPE functions), or providing a full DEMPE analysis may not be relevant to an international related party dealing. This concept applies equally to other industry examples and transaction arrangements including those involving low value-added services. Many contributions to the value of intangibles can be appropriately remunerated determined using a one-sided method based on comparables.

Excessive documentation requirements

The documentation requirements imposed under the Draft PCG present an unreasonably high hurdle, which (as articulated in paragraph 44 of the Draft PCG (referred to below)) will not be achievable for every instance in which intangible assets are created, used or transferred. We appreciate that a selection of documentation

identified may be reasonably requested in the context of higher risk transactions. However, this is not a reasonable expectation for each and every potential transaction involving intangibles and is in stark contrast to OECD guidance. In this regard, we note paragraph 5.28 of the OECD Transfer Pricing Guidelines which provides:

> *"5.28 Taxpayers should not be expected to incur disproportionately high costs and burdens in producing documentation. Therefore, tax administrations should balance requests for documentation against the expected cost and administrative burden to the taxpayer of creating it."*

We consider that the "Documentation and Evidence Expectations" in the Draft PCG could be improved by being drafted more precisely, with respect to specific examples and, importantly, applicable on a prospective basis only. As currently drafted, the Draft PCG's Documentation and Evidence Expectations impose a significant and excessive compliance burden on taxpayers.

Paragraph 48 of the Draft PCG relevantly states:

> "*The Documentation and Evidence Expectations outlined in this section are categorised as:*
>
> • *understanding and evidencing the commercial considerations and your decision making*
>
> • *understanding the legal form of your intangibles arrangements*
>
> • *identifying and evidencing the intangible assets and connected DEMPE activities, and*
>
> • *analysing the tax and profit outcomes of your intangibles arrangements."*

In addition, in several circumstances, the Draft PCG requires that a taxpayer's documentation or evidence regarding Intangibles Arrangements be contemporaneous (see for example, at paragraphs 40, 49, 66, 70), and such requirements are "proposed to apply both before and after its date of issue" (see paragraph 11).

We consider that such a wide scope of Documentation and Evidence Expectations is inappropriate as it does not reflect the commercial reality of business activities relating to Intangibles Arrangements. We note the following examples for illustrative purposes.

- **Know-how**: The Draft PCG states that "[o]ur document and evidence expectations extend to know-how assets relating to business processes [and] interpretation of data" (at paragraph 64). However, "know-how" is recognised at law as being a broad concept, which in many circumstances, forms part of, and is inseparable from, an employee's acquired or inherent state of knowledge. It necessarily travels with an employee during and post-employment. It is unrealistic and impractical for businesses, or individual employees, to identify on an ongoing basis what specific knowledge constitutes "know-how", and to further record such knowledge in separate contemporaneous documentation. This is particularly onerous when such documentation is not otherwise required for a commercial or regulatory purpose, or otherwise at law.
- **Digital databases**: A common circumstance that may arise for a business is where a digital database is maintained, where contributions are made to that database by an Australian taxpayer, and where an offshore related party accesses the content on that database without providing consideration. In these circumstances, it is an unduly onerous exercise to produce contemporaneous documents and evidence in accordance with the Draft PCG, because depending on the view adopted by the taxpayer almost any number of the contributions to the digital database could constitute an Intangibles Arrangement. Further, such factual patterns may already be appropriately accounted for in accordance with the ATO's existing guidance in respect of transfer pricing arrangements (as noted above). Where this is the case, it makes the exercise of creating a specific PCG document redundant.
- **Digital workplaces**: Further, and related to the above, are those circumstances where an intangible asset is managed by a committee and where members of those committee are located in multiple jurisdictions. This is common practice for modern businesses and it is increasingly rare for all persons connected with an intangible asset to be physically located within a single jurisdiction. In these circumstances, it is again an excessively arduous exercise to produce contemporaneous

documents and evidence in accordance with the Draft PCG, particularly in respect of valuations and attribution.

The practical consequence of the above is that, as at the date of the Draft PCG's publication, almost any existing Intangibles Arrangements could be assessed as a high-risk arrangement in accordance with the Draft PCG's Risk Assessment Framework given its unduly onerous documentation requirements, and retrospective application.

Examples of DEMPE functions

The Draft PCG appears to have two distinct focus areas; transactions involving migrations of intangible assets, and transactions which may not involve a migration but involve DEMPE functions in Australia. In either case, detailed analysis and the preparation of documentation is required. This is the case even though not all DEMPE functions are high value creating functions.

Most of the examples given in the Draft PCG are focused on Intangibles Arrangements involving migrations. It would be helpful to taxpayers if the ATO could provide clearer guidance as to what it regards as DEMPE functions, and specifically include examples of transactions not necessarily involving migrations.

Other issues

The Draft PCG seems to suggest the level of engagement a taxpayer could expect in relation to their Intangibles Arrangements at a general level, rather than setting out what is of specific concern to the ATO and what represents a risk and therefore should be focused on. In this regard, the ratings provided are not by reference to high, medium or low risk, but rather are by reference to the level of activity the ATO will undertake when gathering the necessary background information. It would be useful for the Draft PCG to clearly articulate how the ATO will undertake an analysis to assess the underlying risk(s) using the information, and what specifically the ATO would want to see from taxpayers that would mitigate that risk (aside from presenting documentation).

Proposed solutions

The Tax Institute considers that Australian taxpayers and the ATO can reasonably regard the OECD Transfer Pricing Guidelines as the highest practical authority on Intangibles Arrangements (as defined) concerning the potential application of the transfer pricing provisions. This was clearly intended by Parliament when legislating s 815-135.

Therefore, it would be apt for the ATO to seek to strike a more appropriate balance in a final PCG between the documentation and evidence required by the low risk factors of Appendix 1 and paragraph 5.28 of the OECD Transfer Pricing Guidelines (extracted above). In our view, the documentation and evidence expectations set out within the low risk factors of Appendix 1 of the Draft PCG will often exceed the transfer pricing documentation prepared by taxpayers when applying the OECD Transfer Pricing Guidelines in low-risk situations.

As a simple example, it will be plain for many resellers of finished goods to determine that TA 2018/2 should not apply to them because their reselling activities involve incidental (or no) use of brand names. However, unless these taxpayers explicitly produce and maintain written documentation substantiating those situations, it is unclear whether they could be regarded as low risk under the risk factors contained in Appendix 1 of the Draft PCG. If intended, this would be an unwelcome outcome, particularly in the context of other ATO PCGs that focus on more prevalent transfer pricing risks and outcomes (PCG 2017/2 and PCG 2019/1) and do not represent an expansion of core documentation requirements. Such taxpayers would be required to produce additional documentation over and above their transfer pricing documentation in order to be regarded as low risk.

Additionally, we ask that the ATO reconsider the manner by which the Draft PCG may require taxpayers to rate their risk. Specifically, the first bullet point in paragraph 31 should be removed and taxpayers should only be required to disclose arrangements which compare to the high-risk examples mentioned in the second bullet point of paragraph 31.

We consider that the specific concerns with the Draft PCG noted above evidence a broader conceptual issue: that there exists a mismatch between the legal concept of Intangibles Arrangements adopted in the

Draft PCG vis-à-vis the Documentation and Evidence Expectations. The following proposed additional amendments may address some of these concerns.

Firstly, we consider that the object and purpose of the Draft PCG should be more clearly stated, including how its requirements differs from other published guidance that may overlap with its terms (see for example, TR 2014/8 *Income tax: transfer pricing documentation and Subdivision 284-E*). Further, to the extent that the ATO identifies any tax risks which cannot reasonably be mitigated by imposing documentation requirements on taxpayers (see for example, know-how) the ATO should continue to consider whether there are alternative pathways to appropriately manage those risks.

Secondly, we would recommend that the scope of the PCG be revisited and specifically to narrow the areas of focus to those which are of direct concern and have an inherent risk of creating a transfer pricing or other tax benefit. By doing so, the type of documentation would then more appropriately align to the transaction, and the level of documentation can then be tailored to match the scale of risk (rather than purely being an indicator of underlying risk). This aspect is considered further, below. We also note that although other taxes such as withholding tax, CGT and the diverted profits tax are noted to be of concern in addressing Intangibles Arrangements, the Draft PCG and risk factors are almost exclusively scoped in relation to transfer pricing. If the Draft PCG is intended to have such a wide application, it would be useful to include specific factors/indicators of concerns in respect of other taxes and where a specific issue may be present.

Thirdly, the Documentation and Evidence Expectations should be re-drafted to reflect the commercial reality of business activities relating to Intangibles Arrangements. In practice, there are usually only ever a few Intangibles Arrangements inherent to a business that are the key drivers of value. Documentation and evidence requirements should be imposed only in relation to these arrangements, rather than the existing proposal which would require documentation and evidence for all arrangements. A useful starting point is set out at paragraph 44 of the Draft PCG, which states that:

> "*We recognise that certain documents identified in this section may not be relevant to the facts and circumstances of your Intangibles Arrangements or that it may be difficult for you to assess the degree of documentation that is required to assess the risk of your Intangibles Arrangements. The Risk Factors are designed to assist you in this regard.*"

However, we consider that the Risk Factors do not sufficiently assist in this regard and that further consideration should be given to how taxpayers should identify certain Intangibles Arrangements and the degree of documentation in respect of each.

One way in which to resolve this issue may be to implement a materiality threshold in respect of Intangibles Arrangements. For example, the documentation requirements set out in the Draft PCG might only apply to varying degrees depending on the value of the Intangibles Arrangements, or depending on the size of the taxpayer. Such thresholds would ensure that small businesses are not subjected to disproportionate compliance costs associated with the Draft PCG and recognises the difference in how Intangibles Arrangements arise as between local businesses vis-à-vis multinational corporates.

A clear statement as to the implications of the PCG's additional documentation requirements and what is considered a reasonably arguable position for transfer pricing purpose would also be helpful.

Fourthly, we consider that the Draft PCG should be amended so that it applies prospectively (with provision for a transitionary period), and not retrospectively. This recognises the reality that it is unlikely that taxpayers will have produced contemporaneous documents or evidence in accordance with their Intangibles Arrangements consistent with the Draft PCG's requirements, particularly given that the Draft PCG would not have been in place at the relevant time and such documentation is unlikely to have been required for other purposes. It would be an inefficient allocation of resources, and a potentially futile task, to require taxpayers to retrospectively cure their administrative practices in accordance with the Draft PCG's requirements.

APPENDIX B

About The Tax Institute

The Tax Institute is the leading forum for the tax community in Australia. We are committed to representing our members, shaping the future of the tax profession and continuous improvement of the tax system for the benefit of all, through the advancement of knowledge, member support and advocacy.

Our membership of more than 11,000 includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our tax community reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate knowledge and learning.

We are committed to propelling members onto the global stage, with over 7,000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. More than seven decades later, our values, friendships and members' unselfish desire to learn from each other are central to our success.

Australia's tax system has evolved, and The Tax Institute has become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and taxpayers today. We are known for our committed volunteers and the altruistic sharing of knowledge. Members are actively involved, ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.