Legal substance and R&D entity relationships

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The ATO's release of new R&D tax incentive taxpayer alerts in December 2023 (TA 2023/4 and TA 2023/5) signifies upcoming scrutiny on R&D claims. These alerts focus on ensuring that entities claiming R&D tax offsets are legally entitled in accordance with the legislation. Applying TA 2023/4 and TA 2023/5, the ATO may more closely examine the legal and commercial aspects surrounding control, financial risk, and ownership of R&D results. This should compel R&D entities and advisers to move beyond superficial assessments and delve into the rights and obligations of the entity conducting the R&D. It necessitates a thorough evaluation of legal and commercial relationships within multi-entity and multi-jurisdiction groups to ensure compliance and legitimacy in claiming R&D tax offsets.

Executive summary

The ATO has traditionally used taxpayer alerts for the R&D tax incentive to signal concern regarding particular structures or issues, and to mark the commencement of heightened compliance activity.

New R&D tax incentive taxpayer alerts were released in December 2023 (TA 2023/4 and TA 2023/5).

These alerts primarily relate to whether entities registering R&D activities and claiming R&D tax offsets can be shown to be the entity for whom the registered R&D activities are conducted, as required in the legislation (s 355-210 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)).

TA 2023/4 and TA 2023/5 indicate that the ATO will be more frequently scrutinising the legal substance and form of issues around control, financial risk and ownership of the results arising from R&D activities.

The alerts will compel R&D entities and advisers to look beyond whether, merely on face value, R&D activities are being conducted, or whether R&D expenditure is being incurred within a group of entities. Instead, the specific registering R&D entity (and not just the broader group) must be assessed to ensure that it is the entity that legally directs, bears the financial burden of, and will beneficially own the results of the R&D activity.

This requires careful consideration of the legal and commercial relationships between entities within multi-entity and multi-jurisdiction groups.

Background

Taxpayer alerts are specific publications that provide a summary of ATO concerns about new or emerging high-risk tax arrangements which will likely be a focus of future ATO compliance activity.

Taxpayer alerts are intended to be high-impact publications which the ATO uses to bring attention to affected taxpayers and arrangements.

Each taxpayer alert describes an arrangement, the ATO's concerns, and what the ATO is currently doing about such arrangements. Taxpayer alerts do not provide the ATO's view on arrangements but will often state if the ATO expects to issue advice or guidance on the matter following release of the taxpayer alert.

Taxpayers impacted by ATO taxpayer alerts should consider whether they may need to take action to reorganise their affairs, including making a potential disclosure to the ATO for prior years.

In February 2017, the ATO issued multiple taxpayer alerts for issues impacting the R&D tax incentive regarding concerns around R&D claims for software development, ordinary business activities, and other issues.[1] The previous 2017 alerts marked the commencement of a period of heightened compliance activity by both the ATO and AusIndustry, which act as joint regulators of the R&D tax incentive.

The ATO issued two new R&D tax incentive-specific taxpayer alerts on 14 December 2023:

- TA 2023/4, concerning R&D activities delivered by associated entities; and
- TA 2023/5, concerning R&D activities conducted overseas for foreign related entities.

It is expected that these taxpayer alerts may again mark the commencement of increased compliance activity by the ATO.

The December 2023 taxpayer alerts indicate a focus by the ATO on the legal substance and form of whether an R&D entity conducts an activity on its own behalf.

The legal requirement for R&D activities to be conducted on behalf of the registering R&D entity arises legally from s 355-210 ITAA97. This section specifies that R&D activities must be conducted for the R&D entity and not to a significant extent for some other entity.

An exception applies under s 355-220 ITAA97 where R&D activities are conducted for a foreign related entity.

Section 355-210 represents the equivalent provision of the "on own behalf" rule from the former R&D tax concession.

It operates as an integrity provision that generally limits R&D tax benefits to the entity which receives the majority of benefits arising from expenditure on R&D activities. The provision seeks to prevent the duplication of R&D claims by multiple entities where essentially the same R&D activities are involved.

The ATO's view is that the determination of who the R&D activities are being conducted for should be based on a number of factors, including the assessment of which entity:

- has an appropriate degree of control over the R&D activities;
- bears the financial burden or risk of conducting the R&D activities; and
- has effective ownership of the results from the R&D activities.

Whether an R&D activity is conducted for an entity is a matter of fact. It is determined by considering whether the activity is conducted, in substance, at the financial risk of the registering R&D entity and will provide this entity with the majority of knowledge benefits arising from the activity, such as access to intellectual property (IP).

This requires analysis of all factors and documentation to arrive at a determination of whether the registering R&D entity meets the requirements.

While TA 2023/4 and TA 2023/5 are applied to differing applications and areas of concern, the central issue within both alerts is the determination of whether R&D activities are conducted for the registering R&D entity.

TA 2023/4

TA 2023/4 is focused on R&D activities delivered by associated entities.[2]

The ATO notes that its primary concerns are arrangements that:

- incorrectly purport that the registering R&D entity has incurred or paid (or both) R&D expenditure under an agreement with an associate service provider; or
- incorrectly purport that the registering R&D entity has conducted R&D activities on its own behalf when the activities are, in substance, being conducted for an associate service provider.[3]

TA 2023/4 highlights a wide range of considerations when complying with Div 355 ITAA97 and may legally apply to combined concerns around:

- the scope of entities that are eligible R&D entities under s 355-35 ITAA97, which outlines that an eligible entity must usually be a company, and not a discretionary trust, unit trust, partnership or sole trader;
- the "on own behalf" rules derived from s 355-210 ITAA97, which specify that the R&D activity must be conducted for the R&D entity; and
- the associate entity R&D expenditure payment rules under s 355-205 ITAA97.

It is probable that TA 2023/4 is focused on issues considered in *XQDX and FCT*[4] and *Sunlite Australia Pty Ltd v FCT*[5] which found against the taxpayers and broadly involve the following facts and steps:

- a group has historically traded from and conducts R&D activity within an ineligible R&D entity, such as a discretionary trust;
- a special purpose R&D entity is incorporated, or a designation of the existing corporate trustee of the trading trust as an R&D entity is made;
- the ineligible R&D entity continues to employ R&D staff and incur the R&D expenditure which it invoices to a designated R&D entity under a service agreement;
- the ineligible R&D entity also trades with knowledge or IP arising from R&D activity, potentially paying a royalty to the designated R&D entity under a licence agreement; and
- the designated R&D entity registers R&D activity with AusIndustry and reports R&D tax offsets in its tax return.

The ATO appears to be particularly concerned with structures where an ineligible entity, such as a trust, is the entity for which the R&D activities are, in substance, conducted for, although a separate entity is purported to have incurred the R&D expenditure and conducted the activity through the implementation of arrangements. The ATO notes that such arrangements may also include contrived measures attempting to comply with the associate entity payment rules, such as via the use of complex set-offs.[6]

The ATO note in TA 2023/4 concerns arrangements between service providers and an R&D entity that:

- even if legally documented in writing, are inconsistent with the actual commercial substance of a group's operations;
- may satisfy the R&D entity's service payment obligations to the associate service provider by the issuing of shares in the registering R&D entity to the associate service provider (which the ATO considers as not constituting effective payment under TR 2008/5); or
- meet service fee payment obligations through payments in rapid succession using a circular flow of funds, such as a round robin type payment arrangement.

The ATO also notes in TA 2023/4 that, even if an arrangement is effective under the substantive provisions, if it can be objectively viewed that the arrangement was entered into for the purpose of obtaining a tax offset, the general anti-avoidance provisions in Pt IVA ITAA36 may apply to cancel a claimed R&D tax offset (noting that the Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Bill 2020 now extends the concept of tax benefits in Pt IVA (s 177C ITAA36) to R&D tax offsets).

TA 2023/4 will require companies and advisers to assess the legal substance and form of their R&D entities, particularly where they may be operating within a multi-entity group. This may require consideration and documentation of:

- whether a structure has been established to allow a group previously operating through an ineligible entity, such as a trust, to access R&D tax offsets. If so, and if the ineligible entity will continue to largely trade and operate using the results of R&D activity, the risk of TA 2023/4 applying is high;
- which entity (and their controllers and employees) is responsible for conducting and directing the R&D activities, and which specific entity within the group are they making such R&D decisions for;
- financing arrangements and justification that the R&D entity will not be reimbursed for activity in the event of technical failure;
- which entity will ultimately and majorly commercially benefit from R&D activity in the event that technical success of the activity generates commercially exploitable results;
- ensuring that the R&D entity can show compliance with the associate entity payment rules in accordance with ATO guidelines and in a non-contrived way; and
- compliance with the additional integrity rules around market value and reductions to reflect mark-ups.

TA 2023/5

TA 2023/5 is focused on R&D activities conducted overseas for foreign related entities.

The ATO notes that its primary concerns are arrangements that:

- involve the use of an overseas finding related to claims for overseas activities; and
- incorrectly purport the registering R&D entity as having conducted R&D activities on its own behalf, when the activities are, in substance, being conducted for a foreign related entity.

TA 2023/5 highlights a wide range of considerations when complying with Div 355 ITAA97 and may legally apply to combined concerns around:

- the "on own behalf" rules derived from s 355-210 ITAA97, which specify that the R&D activity must be conducted for the R&D entity; and
- if the activities were conducted to a significant extent for the foreign related entity, whether the additional requirements in s 355-220 ITAA97 have been complied with, including the requirement that the R&D activity is conducted solely within Australia.

The title and content of TA 2023/5 suggest that the ATO's main concern relates to where overseas R&D activities are being claimed, and may indicate that, where an R&D entity conducts all R&D activities in Australia, TA 2023/5 may not be applicable. However, issues in TA 2023/5 may apply to arrangements of concern to restrict the eligibility of R&D activities conducted in Australia where it is determined that Australian R&D activities are conducted wholly, or to a significant extent, for a related foreign entity (s 355-210(2) ITAA97).

TA 2023/5 notes that arrangements of concern may display the following features:

- the agreements between the foreign related entity and the R&D entity:
  - are established under the instruction of the foreign related entity and its controllers;
  - result in the foreign related entity ultimately acquiring ownership rights in IP arising from the R&D activity;
  - impose restrictions on the R&D entity's rights around the developed IP;
  - grant to the foreign related entity primary rights to exploit and manage the developed IP; and
  - have a legal form that is inconsistent with the actual commercial substance of the arrangements between the entities;
- the foreign related entity:
  - owns pre-existing IP licensed to the R&D entity to undertake the R&D activity;
  - in substance and effect:
    - controls the strategic decisions regarding the R&D activities, including the instructions given to any contracted CRO of how the R&D activities are to be conducted;
    - assumes the financial and operational risks in relation to conducting the R&D activities, and sets the conditions for initial and subsequent funding of the R&D activities; and
    - will primarily commercially benefit in the event of a successful outcome; and
  - the foreign related entity may itself be contracted by the R&D entity to conduct some, or all, of the R&D activities; and
- the Australian R&D entity:
  - may have limited or no physical presence in Australia;
  - may have one or more foreign resident directors appointed by the foreign related entity;
  - may have an Australian-based resident director that acts in accordance with the directions and wishes of the foreign related entity or its controllers;
  - has few, if any, employees with the technical capability to conduct the R&D activities; and
  - lacks the economic capacity to either conduct the R&D activities or commercially exploit the developed IP in the absence of receiving a refundable R&D tax offset or further funding by the foreign related entity.

TA 2023/5 is perhaps most applicable to biological and medical technology entities, but it may apply to any industry, particularly in situations where:

- a foreign entity may have developed a technology over a number of years prior to the incorporation of an Australian R&D entity;

- a foreign entity incorporates a controlled Australian R&D entity to conduct specific R&D activities, such as a clinical trial investigating a technology previously developed by the foreign entity;
- direction and funding of the activity conducted by the Australian R&D entity is provided by the foreign entity;
- in the event that technical success of the R&D activity registered by the Australian R&D entity generates exploitable results, the foreign entity will primarily commercially benefit; and
- a finding for claiming overseas R&D activity applying s 28C(1)(a) of the *Industry Research and Development Act 1986* (Cth) may be involved.

To the author's knowledge, there has not yet been any cases decided by courts or the AAT involving these circumstances. However, the release of TA 2023/5 indicates that matters may be afoot.

The ATO notes in TA 2023/5 that, even if an arrangement is effective under the substantive provisions, if objectively viewed that the arrangement was entered into for the purpose of obtaining a tax offset, the general anti-avoidance provisions in Pt IVA ITAA36 may apply to cancel a claimed R&D tax offset.[7]

> "… the ATO will look beyond superficial compliance with the main rules on activities and expenditure …"

TA 2023/5 will require companies and advisers to assess the legal substance and form of their R&D entities, particularly in terms of how the Australian entity's R&D activity interacts with foreign related entities. This may require consideration and documentation of:

- what actual R&D activity is being undertaken by the Australian R&D entity, and whether it is undertaking a project of its own, or is merely contributing to a project undertaken by and for a foreign related entity; and
- the legal and commercial substance and form of structural arrangements to determine which entity the R&D activities are conducted for, and whether the "at risk" integrity rule may apply.[8]

Furthermore, where companies are conducting R&D activities on behalf of an associated foreign corporation, they must comply with the specific requirements under s 355-220 ITAA97. Key conditions of this provision include that:

- the R&D activity must be conducted solely within Australia;
- the relevant foreign entity must be located in a country that has a tax treaty with Australia; and
- service agreements must document the basis on which the Australian entity will provide R&D services to the foreign related entity.

Practical considerations and managing risk

So, what can be done if confronted with a structure or an issue exhibiting the risks noted in TA 2023/4 and TA 2023/5?

The unfortunate answer is that there is no easy solution to retrospectively address deficiencies within structures that are flawed with the issues outlined in these new R&D tax incentive taxpayer alerts.

The ramifications of the issues highlighted in the taxpayer alerts can be significant, particularly for TA 2023/4, and have the potential to render entire R&D claims invalid and lead to the imposition of penalties.

Companies and advisers identifying risks based on TA 2023/4 and TA 2023/5 should promptly assess whether continuing to register the R&D activities and claim tax offsets is suitable. A voluntary disclosure to the ATO for historical claims may also be advisable.[9]

To minimise the likelihood of TA 2023/4 and TA 2023/5 applying when commencing R&D activities, a number of measures can be taken to document key items when establishing an R&D entity or project.

In respect of TA 2023/4 (concerning R&D activities delivered by associated entities), these measures include:

- if a group's structure involves the use of a trading, ineligible R&D entity (such as a trust) that has historically conducted the group's R&D, having a new company designated as an R&D entity while the ineligible R&D entity continues to trade or incur R&D costs would lead to a high risk of TA 2023/4 applying. In such cases, advice should be sought on whether it is feasible to restructure into a single, corporate R&D entity which trades, and it should be ensured that the previous, ineligible R&D entity does not conduct activity that would lead to a conclusion that any future R&D activity may be majorly for that ineligible entity's benefit;
- consideration should be given as to how, when and to what degree the R&D entity will benefit commercially from the results of the R&D activity. This may include examining and documenting factors such as:
  - the context and function of the R&D entity within the group;
  - whether the R&D entity will directly sell the results of the R&D activity or derive licence income; and
  - if deriving a licence only, whether there will be another entity within the group that may commercially benefit from the results of the R&D activity to a greater degree than the registering R&D entity. If so, this may indicate a risk of TA 2023/4 applying;

- consideration should be given to the R&D entity's financing arrangements regarding how it will fund the R&D activity, for example:
  - increased complexity such as the use of set-offs or contingencies aggravates the risk of TA 2023/4 applying. Simplified structures such as financing via cash equity contributions or interest bearing full-recourse loans may be considered lower risk;
  - R&D expenditure must not be paid by the R&D entity issuing equity in settlement of its liabilities for incurred R&D expenditure based on TR 2008/5;
  - care should be taken to comply with the associate entity payment rules in a simple and non-contrived manner;
- having the R&D entity incur costs directly from external parties and directly employ R&D staff (rather than have them employed by another entity in the group) may reduce the risk of TA 2023/4 applying by reducing the scope of the costs delivered by associated entities; and
- documentation should be maintained to show how the staff and directors of the R&D entity, as opposed to that of another entity, have made decisions regarding the R&D activities, and that those decisions were for the benefit of the R&D entity, rather than for another entity within the group.

In respect of TA 2023/5 (concerning R&D activities conducted overseas for foreign related entities), these measures include:

- consideration should be given to the purpose of incorporating the Australian R&D entity and the actual R&D activity it will conduct. This may involve:
  - assessment of whether the Australian R&D entity is conducting experiments to develop its own new product or process; or
  - whether the Australian R&D entity's purpose is merely to conduct activities associated with progressing development of a project previously instigated by the foreign related entity. If so, there is a risk the activities are being conducted for the foreign related entity;
- consideration should be given to how the results of the R&D activities will be commercialised and whether the R&D entity or the foreign related entity will be the primary beneficiary of commercialisation rights. Documentation regarding IP rights and global business plans may be relevant; and
- if any Australian R&D activities are, in substance, conducted for the benefit of the foreign related entity, the Australian R&D entity's activities may still qualify under the additional requirements in s 355-220 ITAA97 (R&D activities conducted for a foreign entity):
  - this necessities compliance with several additional rules concerning the relationship with, and location of, the foreign related entity; and
  - service fee income derived by the Australian R&D entity from the foreign related entity under s 355-220 will likely result in the initial cash benefit derived for R&D expenditure being around $0.185 rather than $0.435. However, claiming under s 355-220 may reduce overall risk if the factors in TA 2023/5 are present.

Conclusion

It is anticipated that demonstrating control, financial risk and formal ownership of IP arising from R&D activity will be a large focus of upcoming ATO R&D reviews of multi-entity groups to ensure that R&D activities are conducted for the registering R&D entity.

It is also apparent that the ATO will look beyond superficial compliance with the main rules on activities and expenditure under the R&D tax incentive to look at the legal rights and obligations of an R&D entity. The ATO will also challenge the validity of structures which are documented "on paper" as complying with s 355-210 ITAA97 if, in substance, the risk and benefit of conducting the R&D activity are attributable to an entity other than the registering R&D entity.

TA 2023/4 and TA 2023/5 express concerns over issues related to multi-entity groups, and businesses operating simplified structures using a single, corporate R&D entity may have lower risk of the alerts applying. Accordingly, consideration regarding the requirements of structures and balancing complex issues such as asset protection and R&D eligibility should be weighed when setting up a new business that may include R&D claims.

As the complexity of the group and interactions with associate entities increase, so does the risk of TA 2023/4 and TA 2023/5 applying.

A review of issues under s 355-210 will often inevitably lead to a focus on legal principles and examining documentation showing IP ownership and financial risk. When documenting and implementing an effective structure, legal advice may be required for R&D claims within multi-entity groups.

When dealing with multi-entity groups, R&D entities and advisers must increasingly consider how an R&D entity fits within the group's legal and commercial framework to satisfy s 355-210.

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References

1 TA 2017/5.
2 See the definition of "associates of an entity" in s 318 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).
3 Para 6 of TA 2023/4.
4 [2021] AATA 4070.
5 [2023] FCAFC 43.
6 Para 4 of TA 2023/4.
7 Para 7 of TA 2023/4.
8 Para 6 of TA 2023/4.
9 Para 12 of TA 2023/4; para 10 of TA 2023/5.