New Financial Year, New Tax Developments for Inbound Financing

What should Inbound Real Estate Entities look out for?

24 August 2017

In brief

- Recent changes to the tax regulatory environment may have a significant impact on inbound real estate entities. Many of these are focused on financing transactions – in particular, related party financing transactions – but some have broader effect. Inbound real estate entities with related party financing arrangements including vanilla loans, mezzanine loans and hybrid instruments should consider the application of the existing rules regarding general deductibility of interest and other returns, transfer pricing, thin capitalisation and general anti-avoidance (Part IVA of the *Income Tax Assessment Act 1936*) together with more recent developments, including the Australian Tax Office's (ATO) draft guidance on related party financing transactions, new reporting obligations, the new Diverted Profits Tax (DPT) and the proposed hybrid mismatch rules.
- The ATO released draft Practical Compliance Guideline PCG 2017/D4 on 16 May 2017. The draft guidance introduces a framework for assessing the tax risk of related party financing arrangements, which will be used by the ATO when tailoring its compliance approach to a taxpayer. The guidance, once finalised, is proposed to apply to new and existing financing arrangements of a taxpayer from 1 July 2017. Inbound real estate entities should review their related party financing arrangements against the risk framework to understand the potential implications and whether any action should be taken.
- The Australian version of the DPT came into effect in the new financial year, applicable to income years starting on or after 1 July 2017. The DPT imposes a penalty rate of tax (40 per cent) to profits diverted offshore through related party arrangements. Inbound real estate entities that are Significant Global Entities (SGEs) should review their related party international arrangements to understand the extent to which the DPT may apply.
- The Australian Government has implemented Country-by-Country (CbC) reporting for income years that commenced on or after 1 January 2016. Inbound real estate entities that are SGEs will need to lodge specific transfer pricing documentation in the ATO's approved format within 12 months after the end of their income tax year. SGEs are also now required to prepare and lodge general purpose financial statements (GPFS) with the ATO if they do not already lodge these with the Australian Securities and Investments Commission (ASIC) (or if required to lodge GPFS with

ASIC, do not do so by the time required under the Corporations Act 2001). Significant penalties of up to AU$525,000 can apply for the failure to lodge CbC reports and GPFS (or any other documents required to be lodged with the ATO) that are due to be lodged on or after 1 July 2017.

In detail

The Australian tax regulatory environment has recently seen a significant tightening of tax laws and administrative interpretation, some of which generally apply to all taxpayers whilst others are targeted at large multinational groups operating in Australia (referred to as SGEs, discussed in further detail below). Those relevant to the real property sector are set out in the table below.

Relevant for all taxpayers (refer to Section 1 below)	***Relevant for SGEs (refer to Section 2 below)***
Draft PCG 2017/D4 regarding the ATO's compliance approach to cross border related party financing	Diverted Profits Tax
Proposed hybrid mismatch rules	CbC reporting requirements
	Requirement to lodge General Purpose Financial Statements
	Increased administrative penalties for late and/or incorrect lodgements

The details of the above topics have been the subject of a number of our previous TaxTalk Alerts. This TaxTalk Alert does not seek to reiterate the details of the all of the above rules, but rather to provide further insights into the application of the relevant tax developments to real estate entities investing in and developing properties in Australia. The focus of this TaxTalk Alert is on inbound related party financing.

Are you a SGE?

An entity is regarded as a SGE for a particular income year where it is a 'global parent entity' whose 'annual global income' is at least AU$1 billion in the income year, or it is a member of a group of entities that are consolidated for accounting purposes as a single group whose global parent entity's annual global income is AU$1 billion or more in that income year. The global parent entity's annual global income is based on the total annual income as shown in the global financial statements for the previous year.

This definition means that entities need to understand whether their financial information is or will be consolidated into the financial statements of one of its investors. For example, an Australian entity that is equity accounted at the head entity level (i.e. the head entity is not required to prepare financial statements which consolidate the Australian entity) can disregard the head entity's annual global income for the purposes of determining whether or not it is a SGE. Many global real property funds may not be required to consolidate all of their portfolio investments for accounting purposes and this may impact whether any Australian investee entities are SGEs.

An entity's status as an SGE must be assessed on an annual basis, therefore an entity that is not a SGE for a particular income year will need to continue to monitor its status going forward. This is relevant for real estate entities which are expecting growth in their global operations, gains on disposal of properties or are nearing completion of the construction phase of their projects. Accounting standards or commercially accepted accounting principles in the relevant foreign jurisdiction may also impact the classification of any Australian entities.

Section 1: Issues relevant for all taxpayers (i.e. SGEs and non-SGEs)

Application of the transfer pricing rules to financing transactions

The ATO are intensely focussed on cross-border related party financing arrangements and on 16 May 2017, issued for public comment draft Practical Compliance Guideline PCG 2017/D4 which sets out the ATO's compliance approach to the taxation outcomes associated with an inbound or outbound 'financing arrangement' or a related transaction or contract, entered into with a cross-border related party.

The draft guidance includes a framework for assessing the tax risk of intercompany financing transactions. Transactions rated as low risk under the framework are unlikely to attract ATO attention, while transactions rated as high risk are more likely to be subject to ATO scrutiny, especially where the dollar values are material. Risk is assessed based on a number of quantitative factors (e.g. the spread between the intercompany interest rate and the group's external funding costs, leverage of the borrower, and interest coverage ratios) and qualitative factors, some of which are not related to transfer pricing (e.g. whether a hybrid entity or instrument is involved and the tax rate in the lender's jurisdiction).

When finalised, the new guidance is proposed to apply to new and existing financing arrangements from 1 July 2017. Taxpayers will need to assess how their financing arrangements rate against the ATO's risk framework. It is likely that many real estate groups will have existing related party funding arrangements in place which could be rated as moderate to high risk under the ATO framework, even in cases where the taxpayer has developed robust transfer pricing documentation.

It is noted that while the PCG is still in draft form, it is in practice already being applied by the ATO when considering approval decisions and tax conditions for Foreign Revenue Investment Board (FIRB) applications.

In relation to prior income years, the Commissioner of Taxation has given an undertaking that in respect of tax shortfalls which might arise from the adjustment of pricing or levels of debt of financing arrangements so as to fall within the 'Green zone', he will exercise his discretion to remit:

- penalties on any shortfall to nil, and
- shortfall interest charges to the base rate.

The 'amnesty' is proposed to apply for 18 months from 16 May 2017 (i.e. the date of issue of the draft Guideline) or the effective date for any new schedule issued to this draft Guideline. However, it is important to note that just because a loan is outside the green zone does not mean the pricing is incorrect.

It will be important that taxpayers can evidence comparable third party transactions to support the arm's length conditions of their loans. One of the challenges with subordinated and mezzanine loans in the real estate industry (particularly property development) is the private nature of these transactions. This means that finding strong comparables can be difficult, notwithstanding the abundance of third party transactions in the market.

Taxpayers will therefore need to carefully consider what action to take in response to the ATO guidance. Options may include preparing additional analysis and documentation to defend the existing position, engaging with the ATO to agree on a mutually acceptable transfer pricing approach and/or changing the terms of the existing arrangements to move toward a lower risk zone. The transfer pricing implications in the lender's jurisdiction would need to be considered before any changes are made.

Proposed hybrid mismatch rule

The Australian Government announced in the 2016 Federal Budget that it will implement the anti-hybrid rules developed by the Organisation for Economic Cooperation and Development (OECD). A further

announcement was made by the Government in the 2017 Federal Budget relating to specific rules to eliminate hybrid mismatches that occur in relation to regulatory capital issued by certain financial institutions such as banks and insurers. None of these announcements are law as at the date of this paper, however draft legislation is expected to be released for consultation in early 2018.

It is anticipated that the Australian version of the anti-hybrid rules may include the OECD's proposed 'imported mismatch rule', which is designed to prevent taxpayers from indirectly shifting tax advantages arising from a hybrid mismatch from a jurisdiction that has not implemented the anti-hybrid rules. The imported mismatch rule is expected to increase the complexity of the anti-hybrid rules and to have broad ramifications as it extends to both financing and non-financing payments (for example, deductions can be disallowed for a broad range of payments including interest, royalties, rents and payments for services).

If the OECD imported mismatch rule is legislated in Australia, taxpayers will face practical difficulties as they may be required to:

- trace funds flows through chains of entities in a global group, and apportion deduction denials across jurisdictions that have implemented this rule, and
- understand the foreign tax treatment of payments that have no direct connection with their particular (Australian) operations, and keep abreast of legislative developments in foreign jurisdictions that may change the position taken in Australia.

Although the exact form of the proposed anti-hybrid rules in Australia is not yet known, taxpayers should be aware of the proposals and consider their potential impact on future and existing transactions.

Section 2: Issues relevant to SGEs

Diverted Profits Tax

Broadly, the DPT applies where a taxpayer that is a SGE obtained a 'DPT tax benefit' as a result of entering into a scheme involving a foreign related entity and an objective conclusion can be made that there was a 'principal purpose' on enabling the relevant taxpayer to obtain an Australian tax benefit, or to obtain both an Australian tax benefit and reduce foreign tax liabilities. The DPT is extremely broad and applies to both financing and non-financing arrangements.

Although the DPT rules have been incorporated into Australia's existing anti-avoidance rules in Part IVA, the 'principal purpose' test is a lower threshold to meet than the 'sole or dominant purpose' test which is used in the other parts of the general anti-avoidance provisions. This is clearly intended to ensure that the DPT rules can capture a wider range of international arrangements.

Inbound financing for real property entities could be subject to DPT. There are certain carve-outs from DPT which includes having sufficient economic substance. If DPT applies and the debt levels of the taxpayer fall within the thin capitalisation limit, only the pricing of the debt and not the amount of the debt should be taken into account in determining any DPT liability.

Where the DPT applies:

- The Commissioner will impose a 40 per cent penalty tax on the diverted profits (the 'DPT assessment')
- The taxpayer will be required to pay the DPT assessment within 21 days of issue
- The taxpayer has 12 months after the DPT assessment to lodge evidence with the ATO and defend its position (the 'review period'), and
- Evidence in the custody and control of the taxpayer that is not submitted in the review period will not be subsequently admissible in court.

Relevantly, the DPT is a separate penalty tax to an income tax. Therefore, where an entity has prior year losses and the Commissioner makes a DPT assessment, the entity cannot use its prior year losses to offset the DPT assessment, and the DPT assessment will not have any impact on the amount of prior year losses that may be carried forward to offset income in future periods even where they arise from a DPT benefit such as overstated deductions.

Some investment vehicles are excluded… but what about other group entities?

Real estate investors may be aware that taxpayers that are managed investment trusts (MIT), foreign collective investment vehicles with a widely held membership, entities owned by foreign government, complying superannuation entities and foreign pension funds are expressly excluded from the DPT. It is important to note that the DPT may still apply where a scheme involves such an entity but where there is a separate Australian taxpayer that is not specifically excluded from the DPT. For example, while a MIT is an excluded entity, the investors of a MIT and the sub-trusts of a MIT are not excluded from the DPT rules merely because they invest in or are held by an excluded entity.

Do any of the carve-outs apply?

The DPT does not apply where one of the following carve-outs is satisfied:

- **$25 million income test** – the Australian income (which is broadly defined) of the global group (i.e. the taxpayer and its associated entities that are members of the same global group) does not exceed AU$25 million. Australian income includes any DPT tax benefit to the extent that it relates to an amount that is not being included in assessable income. That is, the AU$25 million threshold is determined on the basis of the income that the Australian entity should have received on arm's length transactions.
- **Sufficient foreign tax test** – the increase in the foreign tax liabilities from the arrangement is equal to, or exceeds 80 per cent of the corresponding reduction in the Australian tax liability of the relevant taxpayer. When calculating the Australian tax liability, it is noted that the Australian tax liability is reduced by any withholding tax payable by the taxpayer in respect of the tax benefit.
- **Sufficient economic substance** – the DPT will not apply if, in relation to the DPT tax benefit, it is reasonable to conclude that the profit made by each entity as the result of a scheme reasonably reflects the economic substance of the entity's activities in connection with the scheme. This carve-out requires an analysis of the economic substance of the activities of the relevant taxpayer in connection with the scheme (and any other associate entity connected with the relevant scheme) and the entity's role within the overall scheme, rather than the overall economic substance of the entity itself. Once the entity's economically significant functions have been identified, consideration must be given as to whether the profits made by this entity are commensurate with the activities (or lack of activities) undertaken. This requires transfer pricing analysis of factors such as the functions performed by the entity, assets used and risks assumed by the entity in relation to the scheme.

How is the DPT tax benefit calculated?

Similar to the identification of a tax benefit under Part IVA, the DPT tax benefit under a scheme is identified by reference to the reasonable alternative postulate. Of note, example 1.2 in the Explanatory Memorandum to the legislation that introduced the DPT specifically stated that there is no DPT tax benefit if the interest deduction of a taxpayer under the scheme is lower than what it would have been under a reasonable alternative postulate, even if the interest had been paid to a lower taxing jurisdiction.

Interactions between the thin capitalisation and transfer pricing rules

Where the DPT tax benefit is in the form of a debt deduction, the DPT may apply to a financing arrangement entered into by an Australian taxpayer even though its debt levels are within the Australian thin capitalisation threshold. The DPT tax benefit in this case should be the difference between the interest expense actually incurred by the taxpayer and the interest expense which should have been incurred had an arm's length interest rate (applicable under a reasonable alternative postulate) been applied to the amount of debt issued by the taxpayer. Effectively, this means that where the debt level of a taxpayer is within the Australian thin capitalisation threshold, DPT cannot apply to determine the level of debt that the taxpayer should have. Instead, it is limited to determining the pricing of the debt that the taxpayer actually has in place.

Increased transparency and reporting requirements

In line with the recommendations from the OECD Base Erosion and Profit Shifting (BEPS) project, Australia has implemented CbC reporting for income years that commenced on or after 1 January 2016. The CbC reporting obligations apply to all Australian taxpayers that are SGEs, regardless of the size of the Australian operations. Within 12 months after the end of its income tax year, an SGE is required to provide the ATO with three statements – a CbC report, a local file and a master file.

The statements must be provided in the ATO's 'approved form' and it is important to be aware that the local file format required in Australia is very different from other jurisdictions. The local file must be lodged in a specific digital format, and requires the taxpayer to report very detailed information about their international related party dealings, including providing copies of relevant agreements to the ATO.

The information the ATO gathers through the new reporting regime will enable it to readily identify taxpayers who have arrangements in place which potentially fall within the scope of the DPT and/or financing structures which are high risk under the new ATO guidance. Taxpayers will therefore need to ensure that the information they report to the ATO is accurate and that they have adequate documentation in place to support the transfer pricing positions adopted.

Where the CbC report, local file or master file are not lodged by their due date, there may be significant penalties of up to AU$525,000 per statement.

General Purpose Financial Statements

There is a new requirement for corporate tax entities that are SGEs to prepare and lodge GPFS with the ATO if they do not already lodge GPFS with ASIC (or, where required to lodge GPFS with ASIC, do not lodge within the time frame provided by the Corporations Act 2001). The new financial reporting requirement applies to income years beginning on or after 1 July 2016. Accordingly, for entities with 31 December year end for tax purposes, the new requirement applies from 1 January 2017. The GPFS must be prepared in accordance with accounting principles or if they do not apply, commercially accepted principles relating to accounting.

Where an entity is required to provide GPFS to the ATO, they will need to be submitted to the ATO by the time of filing the relevant taxpayer's income tax return. The new increased administrative penalties for SGEs of up to AU$525,000 will apply to late lodgement of the GPFS.

The new reporting obligation is unclear in a number of aspects and the ATO has been consulting since mid-2016 on various issues, including whether lodging the consolidated financial statements of the ultimate foreign parent would satisfy these new rules. We are expecting the ATO will issue further guidance on this point shortly.

The takeaway

With the ATO guidance on assessing risk for cross border related party financing proposed to apply from 1 July 2017, all taxpayers should begin assessing newly created and existing cross-border related-party financing arrangements against the risk framework provided in the guidance even though it has not been published in final form. This will provide taxpayers with an indication of the compliance approach that can be expected from the ATO going forward.

Many of the new measures highlighted above are limited in their application to SGEs. As some real estate entities have fluctuating revenue streams due to the profile of their property portfolios, we recommend regularly monitoring the group's revenues to ensure that if the AU$1 billion annual global income threshold is met, any additional reporting obligations and risks are carefully assessed and managed.

The DPT is now in effect for June year-end SGEs, and will commence from 1 January 2018 for 31 December year-end SGEs. SGEs should perform analysis as early as possible to understand the extent to which the DPT may apply and to determine whether any carve-out clauses could apply and be sustained.

SGEs should also ensure that they are prepared to comply with the new reporting requirements, including the requirement to lodge GPFS with the ATO if they do not already lodge GPFS with ASIC, and new transfer pricing reporting obligations. With the CbC reporting obligations already in effect for income years that commenced on or after 1 January 2016, SGEs will need to lodge a CbC report, local file and master file with the ATO within 12 months after the end of their income tax year. Importantly, taxpayers also should be considering which compatible software solutions will be utilised to produce validly formatted CbC reports that can be lodged with the ATO. Where the CbC report, local file, master file or GPFS (where required) are not lodged by their respective due dates, there may be significant penalties of up to AU$525,000 per document.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Sue Ann Khoo, Sydney
+61 (2) 8266 3050
sue.ann.a.khoo@pwc.com

Josh Cardwell, Sydney
+61 (2) 8266 0532
josh.cardwell@pwc.com

Christian Holle, Sydney
+61 (2) 8266 5697
christian.holle@pwc.com

James Nickless, Sydney
+61 (2) 8266 3246
james.nickless@pwc.com

Nick Houseman, Sydney
+61 (2) 8266 4647
nick.houseman@pwc.com

Lyndon James, Sydney
+61 (2) 8266 3278
lyndon.james@pwc.com

Wendy Hartanti, Sydney
+61 (2) 8266 1502
wendy.hartanti@pwc.com

© 2017 PricewaterhouseCoopers. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers a partnership formed in Australia, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity. This publication is a general summary. It is not legal or tax advice. Readers should not act on the basis of this publication before obtaining professional advice. PricewaterhouseCoopers is not licensed to provide financial product advice under the Corporations Act 2001 (Cth). Taxation is only one of the matters that you need to consider when making a decision on a financial product. You should consider taking advice from the holder of an Australian Financial Services License before making a decision on a financial product.

Liability limited by a scheme approved under Professional Standards Legislation.