
New ATO guidance on cross-border related party financing

17 May 2017

In brief

The Australian Taxation Office (ATO) has publicly made it very clear there is intense focus on cross-border related party financing arrangements. Multinational taxpayers will now have more information to self-check the ATO assessment of tax risk associated with their related party financing arrangements. This new ATO guidance has been released in the form of a Practical Compliance Guideline.

This guidance sets out a multifaceted framework for how the ATO differentiates risk (according to six colour-coded risk zones) and how it tailors its compliance approach according to the features of the related party financing arrangement, the profile of the parties and the choices and behaviours of the multinational group.

If your related party financing arrangement falls outside the low risk category, you can expect the Commissioner of Taxation will monitor, test and/or verify the tax outcomes of your related party financing arrangement. The higher the risk rating, the more likely an arrangement will be subject to specific ATO review and scrutiny.

In detail

On 16 May 2017, the ATO 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.

Specifically, the framework set out in the draft Guideline is aimed to assist taxpayers:

- assess the tax risk of a related party financing arrangement in accordance with the ATO's risk framework, and
- understand the compliance approach the Commissioner is likely to adopt given the risk profile of a related party financing arrangement.

Although the draft Guideline, once finalised, will have effect from 1 July 2017, it will apply to existing and newly created financing arrangements, structures and functions. In addition, taxpayers are effectively put on notice to review existing financing arrangements and where necessary, potentially amend prior year returns to reflect adjusted pricing or levels of debt of financing arrangements.

It is made very clear in the draft Guideline that the principles set out in the Guideline do not constitute a 'safe harbour' and it is not a public ruling. The purpose of the document is to give taxpayer's confidence that if their circumstances align with the "low risk category", the ATO will generally not allocate compliance resources to test the relevant tax outcomes of the related party financing arrangement.

The Schedule currently attached to the draft Guideline sets out the risk indicators and framework for cross-border related party debt funding and is limited to risks relating to the application of the transfer pricing rules. Additional schedules may be included as part of this draft Guideline in the future.

How will the Commissioner assess risk on a related party financing arrangement?

Generally, the ATO expects any pricing of a related party debt to be "in line with the commercial incentive of achieving the lowest possible 'all-in' cost to the borrower". This means there is an expectation that, in most cases, the cost of the financing should align with the costs that could be achieved, on an arm's length basis, by the parent of the global group to which the borrower and lender both belong.

The draft Guideline indicates that the Commissioner's compliance approach will vary depending on the risk rating of the related party financing arrangement. The ATO's related party financing arrangement risk framework is made up of six colour-coded risk zones.

Table 1: Risk zones and ATO compliance action

Risk Zones	ATO compliance actions
White zone - arrangements already reviewed and concluded by the ATO	No further ATO review would be conducted, so long as there has been no material change in the conditions of the related party financing arrangement including the terms, pricing, global group funding arrangements, comparability factors and/or risks since the time of the agreement, decision or review.
Green zone – low risk	ATO will generally not apply compliance resources to the arrangement, other than to confirm certain facts and to check eligibility.
Blue zone – low to moderate risk	ATO will actively monitor arrangements using available data and will review arrangements by exception. Alternative dispute resolution (ADR) might be effective in resolving any areas of difference.
Yellow zone – moderate risk	ATO will work with taxpayer to understand and resolve areas of difference. ADR might be effective in resolving any areas of difference.
Amber zone – high risk	ATO reviews are likely to be commenced as a matter of priority. The ATO will work with taxpayer to understand and resolve areas of difference. ADR might be effective in resolving any areas of difference.
Red zone – very high risk	ATO reviews are likely to be commenced as a matter of priority. Cases might proceed directly to audit. Taxpayer will not be eligible for access to the advance pricing agreement (APA) program. The ATO is likely to use formal powers for information gathering.

In relation to related party debt, the different risk zones reflect a cumulative assessment of the presence of various qualitative and quantitative risk indicators covering:

- Price of debt relative to global group cost of debt, traceable third party debt, and relevant third party debt of borrowing tax entity
- Leverage of borrower of the Australian taxpayer and a comparison to the leverage of the global group
- Interest coverage ratio
- Appropriate collateral - security, guarantee and/or covenants
- Subordinated or mezzanine debt
- Headline tax rate of lender entity jurisdiction
- Currency of debt is different to operating currency (i.e. currency in which borrower earns the majority of its revenues)
- Involves an arrangement covered by a Taxpayer Alert
- At least one party is a hybrid entity
- Presence of exotic features or instruments such as, but not limited to, payment-in-kind or other forms of interest payment deferral, promissory notes or other instruments which do not provide rights to foreclose/accelerate repayment, convertibility to equity or other exchange, and
- Sovereign risk of borrower entity as determined as per Moody's, Standard and Poor's or Fitch.

The existence of the following features in a financing arrangement will typically result in an automatic rating outside of the "Green zone – low risk":

- currency of the related party debt is not the same as the operating currency of the borrowing tax entity
- use of related party derivative instruments
- hybrid entity, and
- exotic features.

If the ATO conducts a review of a related party financing arrangement, it might take into account factors beyond those set out in the draft Guideline including, among other things, the evidence which supports the commerciality of the arrangement.

What are taxpayers expected to do?

The ATO expects that taxpayers will need to test each financing arrangement entered into with a related party that is not a resident of Australia at the start of each income year and, where a financing arrangement is entered into during an income year, at the time it is entered into.

The risk rating for a related party financing arrangement will need to be tested using the method set out in the schedule to the Guideline and the outcomes compared against the applicable risk zones.

Determining a risk zone involves assessing the extent to which the ATO considers the conditions that exist for a related party debt might give rise to a transfer pricing benefit, having regard to various indicators the ATO considers relevant to determining the existence of arm's length conditions.

It is also imperative that taxpayers document their self-assessment of risk for a related party financing arrangement. It is clearly stated in the draft Guideline that a taxpayer who is unable to provide evidence to support their risk assessment, might be subject to further ATO compliance activity.

Furthermore, a taxpayer might be required to disclose whether they have self-assessed the risk rating of their related party financing arrangements. For instance, a taxpayer that is required to complete a Reportable Tax Position (RTP) Schedule will be asked whether they have tested the extent to which the risk indicators outlined in this draft Guideline are present in the actual conditions of a related party financing arrangement, and if so, asked to disclose the self-assessed risk zone.

What should taxpayers do about pre-existing arrangements?

The Commissioner recognises that taxpayers have pre-existing cross-border related party financing arrangements that may not fall within the low risk green zone and that some taxpayers might modify their related party financing arrangements to fall within the “Green zone” prospectively.

In relation to prior income years, the Commissioner 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

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.

This undertaking is conditional on the taxpayer making a full and true voluntary disclosure, and not having tax losses carried forward to later income years at the time of voluntary disclosure.

Taxpayers that do not revisit prior income years might be subject to a tougher ATO compliance approach for those years akin to those outside of the “Green zone”.

ATO to continuously review its guidelines

The use and application of the ATO’s Guideline will be under continuous ATO review over the next three years. This means that additional schedules may be included in the future to provide specific risk indicators for particular types of entities or other financing arrangements, such as financial guarantees, interest free loans and related party derivative arrangements.

The takeaway

Over the past 18 months or so, the ATO has issued numerous Taxpayer Alerts which have involved financing arrangements. This draft Guideline seeks to identify and describe the broad features and attributes of related party financing arrangements considered by the ATO to indicate a risk of not complying with the Australian taxation laws.

The use of framework is complex and may not be straightforward in many cases. Our expectation is that a large proportion of inter-company financing arrangements will fall out of the “green zone”.

In considering how to respond, taxpayers will need to carefully balance a number of considerations. For many taxpayers they will have invested in developing robust transfer pricing documentation in accordance with the Australian requirements and will have adopted positions that are considered correct under the transfer pricing legislation, despite a high risk rating under the ATO’s methodology. Defending this position may involve considerable resources and management time. Equally, the perspective of the foreign jurisdiction will be critical in deciding what action to take. Any actions taken to move into the “Green zone” may in fact result in increasing the transfer pricing risk in the counterparty jurisdiction.

Comments can be made on the draft PCG by 30 June 2017.

Let's talk

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

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