AUSTRALIAN TRANSFER PRICING ALERT

MAY 2017 **ISSUE 14**

CROSS BORDER RELATED PARTY FINANCING ARRANGEMENTS ARE FIRMLY WITHIN THE ATO SIGHTS

In April 2017, the Full Federal Court ruled against Chevron Australia Holdings Pty Ltd (Chevron Australia) in favour of the Australian Taxation Office (ATO) on appeal. The case was heard in relation to the transfer prices on intragroup financing between the overseas related party and the recipient of funds, Chevron Australia. This was the longest running transfer pricing legal case in Australia, and the ATO win is significant in the Australian, and possibly global, transfer pricing landscape. Given the significance of the win, this is definitely not the last intragroup financing case we will see the ATO challenge.

Possibly encouraged by the Chevron Australia decision, on 16 May 2017 the ATO issued a draft Practical Compliance Guidance PCG 2017/D4 (PCG) outlining the risk assessment framework for cross border related party financing arrangements. This guideline has been anticipated for some time but is clearly timed to be released shortly after the Chevron decision - while the issues surrounding the related party debt are in the media spotlight.

The guideline follows the similar traffic light risk rating approach to the widely discussed marketing hubs paper issued by the ATO this year. In an attempt to produce a 'one size fits all' guidance the ATO overlooks the complexity and multitude of possible arrangements when dealing with related party debt and PCG may result in some puzzling outcomes on application. The PCG however is a welcome tool and needs to be taken for what it is – an insight the ATO provides to taxpayers on how it will assess risk under financing arrangements and what to expect from the ATO based on these outcomes.

While the risk assessment using the PCG is not compulsory for the majority of taxpayers, multinationals are well advised to use the guidance not only to assess the risk but to plan mitigation strategies, if necessary.

The PCG's potential effect on taxpayers

By issuing the PCG, the ATO will be seeking to influence behaviours amongst taxpayers in relation to high versus lower risk financing arrangements, thereby arguably encouraging taxpayers to restructure their funding operations to minimise audit and review risks.

The draft PCG deals with taxation issues associated with cross-border related party financing arrangements and is effective from 1 July 2017. It provides no guidance on how taxpayers can comply with the arm's length principle, which underpins the transfer pricing legislation. Instead, it is a risk assessment tool that uses a structured albeit complex checklist approach that allows taxpayers to self-assess their risk.

SPECIALISATION

Transfer pricing

CONTACT

ZARA RITCHIE
Global Lead, Transfer Pricing,
Melbourne
Tel: +61 3 9605 8019
zara.ritchie@bdo.com.au

NATALYA MARENINA
Principal, Transfer Pricing,
Sydney
Tel: +61 2 8264 6649
natalya.marenina@bdo.com.au

ANTHONY HAYLEY
Associate Director, Transfer Pricing,
Brisbane
Tel: +61 7 3173 5412
anthony.hayley@bdo.com.au

NICK DRIZEN
Principal, Transfer Pricing,
Perth
Tel:+61 8 6382 4661
nick.drizen@bdo.com.au

The PCG follows a traffic light risk rating approach allowing taxpayers to derive a risk rating, ranging from 'Green zone' (i.e. safe from the ATO review apart from exceptional circumstances) to 'Red zone', (i.e. likely to be subject to immediate ATO review or audit).

The framework is not straightforward and concentrates on a number of factors including:

- Terms of the debt (i.e. subordinated or senior, collateral, currency, exotic features, etc.)
- Interest cover and leverage ratios, compared to that of global group
- Interest rate on the loan as compared to various third party debt either within the global group or held by the taxpayer
- Headline tax rate of the lender
- A number of other factors.

It should also be noted that there is a lack of consistency on how the ATO risk assesses inbound versus outbound loans, raising a concern that loans following the same policy will be assigned different risk ratings depending on whether they are inbound or outbound. This of course raises a question on international response to such a risk assessment tool and also highlights the one-sided nature of the PCG.

Following the self-assessment of risk, taxpayers will be able to place themselves in a certain risk zone and get an insight as to what attention to expect from the ATO.

ZONE	RISK FRAMEWORK	WHAT TO EXPECT?
White	-	Arrangements already reviewed and concluded by the ATO or a Court
Green	Low	ATO may verify all calculations and risk assessments
Blue	Low to Moderate	ATO will actively monitor financing arrangements with Alternative Dispute Resolution (ADR) as a viable option to resolve differences
Yellow	Moderate	ATO will work with taxpayers to understand and resolve differences with ADR as a viable option to resolve differences
Amber	High	ATO review is likely to commence as a matter of priority with ADR as a viable option to resolve differences
Red	Very High	ATO likely to commence reviewing activities (including audit), through use of formal powers, with no access to the APA program and limited ability to resolve through settlement and ADR

In an attempt to produce a one stop shop guidance, the PCG overlooks the complexity and multitude of possible arrangements and, in some cases, will result in puzzling outcomes on its application. There are numerous taxpayers with loans from independent financiers that are likely to fall outside of the 'Green zone' for commercial reasons alone, highlighting the lack of commercial focus of the PCG. As such, although the PCG's impact will be far reaching, affecting all ypes of taxpayers and industries, it should be treated as a risk assessment tool rather than a conclusive answer to the transfer pricing questions. Just because a taxpayer's risk rating is ranked above green doesn't mean the transfer pricing position is wrong or unsupportable. However, the ATO expects taxpayers who fall into the high risk zone to start discussions on how to manage the resulting risk.

Self-assessment using this guideline is not compulsory for the majority of taxpayers. However, any business notified by the ATO to complete the Reportable Tax Position Schedule will have to self-assess the risk rating of related party financing arrangements. The ATO will allow taxpayers 18 months grandfathering period in which to self-assess and amend related party debt (both existing and newly created) to fall into the 'Green zone', with zero penalties.

We would encourage all taxpayers to review their arrangements with the PCG in mind but to act in a way that makes commercial sense for the Australian taxpayer and the group as a whole, taking the possibility of ATO action into account.

It would be unreasonable to expect all taxpayers to structure their arrangements to fall within the 'Green zone' as that may be uncommercial not only in the context of the affairs of the Australian taxpayers but also in the context of the whole multinational group. The PCG itself also acknowledges that falling into the higher risk zone does not automatically mean that the arrangement is not arm's length.

As outlined above, the PCG is a draft document and there is a consultation period with comments due by 30 June 2017. Please reach out to your BDO transfer pricing or tax adviser if you would like to partake in this consultation process by sending through to us your comments.

Key actions for Australian taxpayers

1. We recommend that all taxpayers with related party debt assess their arrangements against the ATO framework and, depending on the outcome, revisit their financing arrangements
2. Both the Chevron decision and PCG show the importance of properly analysing, documenting and evidencing intragroup financing arrangements, having regard to commerciality and ensuring that the arrangements do not substantially deviate from Group policies. Taxpayers should consider and explore all options that would be realistically available to the borrower in a hypothetical arm's length scenario, to ensure that the arrangement entered into is commercially viable and supportable
3. Consider various risk mitigation strategies, such as restructuring, preparing solid documentation of the arrangements, or agreeing a Private Ruling or Advance Pricing Agreement with the ATO.

Please reach out to your BDO transfer pricing or tax adviser if you would like to discuss your arrangements and potential risk mitigation strategies that might be suitable for you.

MORE INFORMATION

1300 138 991
www.bdo.com.au

NEW SOUTH WALES
NORTHERN TERRITORY
QUEENSLAND
SOUTH AUSTRALIA
TASMANIA
VICTORIA
WESTERN AUSTRALIA