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Global Tax Alert
News from Transfer Pricing

Australia: A detailed review of the ATO compliance approach to related party derivative arrangements and total return swaps

Executive summary

On November 27, 2019, the Australian Taxation Office (ATO) issued the final version of Schedule 2 – "Related party derivative arrangements" – to Practical Compliance Guide 2017/4 (**PCG**). The PCG sets out the ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions" (ATO link).

A review period of over 15 months following the earlier draft issued in August 2018 resulted in several useful clarifications but no major conceptual changes. Taxpayers, including those who waited for more clarity, need to act now. Schedule 2 is effective from 1 January 2019. All taxpayers subject to the PCG including banking and capital markets, insurance entities and financing entities (which do not contain an Authorized Deposit-taking Institution (ADI) or an Australian securization vehicle in the group) are required by Schedule 2 to analyze and score:

- Every foreign derivative transaction with a related-party which hedges a financial transaction
- Total return swaps irrespective of whether they are related to a financing arrangement or are with a related party

The PCG is stated to be a guide to enable taxpayers to self-assess the ATO perception of their compliance risk, with color-coded risk levels ranging from green (low risk) to red (very high risk).

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Taxpayers subject to the 2019 Reportable Tax Positions (RTP) disclosures must disclose their PCG risk classification. The risk zones might impact ATO compliance activity relating to deductibility of payments, liability to withholding tax, transfer pricing rules, including the reconstruction provisions, and application of the general anti-avoidance rule (Part IVA).

Schedule 2 states that the ATO sees derivatives used for commercially rational hedging purposes mostly with unrelated parties. If an arrangement with a related party is not backed out to the external market on exact mirror terms, this alone will elevate taxpayers to the halfway mark of a high-risk rating before consideration of any of the other 14 factors.

No points are added to the risk score if the terms of the derivatives reflect terms that would be found in an equivalent arrangement between non related parties dealing at arm's length but other factors can still apply and lift the arrangement into an elevated risk zone.

Schedule 2 now provides guidance to assist taxpayers who may wish to transition their relevant derivatives into the green zone (low risk) and seek, in certain circumstances, remission of shortfall penalties and interest (to the base rate) until 30 June 2020.

Taxpayers in the red zone (very high risk) can expect significant ATO examination of their positions.

Detailed discussion

Overall, the PCG does not apply, broadly, to members of groups containing an ADI, an Australian securitization vehicle, a taxpayer appropriately applying the simplified transfer pricing record keeping options in relation to loans or a form of Islamic finance.

Scope of Schedule 2 includes all total return swaps

Schedule 2 sets out specific risk indicators for two types of arrangements – related party derivative arrangements and all total return swaps (**TRS**):

- **Related party derivative arrangements other than TRS**: These are derivative arrangements with related parties that are used to hedge or manage the economic exposure of a company or group of companies. The ATO is concerned these arrangements can result in profit shifting within a related-party group.
- **All TRS whether or not with a related party**. Here the scope of the Schedule is broadened, requiring the TRS to be scored even where the parties are not related: there is no need for the TRS to be related to a financing arrangement. The examples in Schedule 2 deal with total return asset swaps in the infrastructure and property development industry.

If the terms and conditions of the related-party derivative arrangement (the first category) are backed out to an independent counterparty on mirror terms, then the arrangement would be scored in either the green or blue zone. If this is not the case, the ATO will require taxpayers to continue with risk scoring the derivative. This includes where the derivative exists for commercially rational hedging purposes (to manage an economic exposure for a company or group of companies). There is no such "mirror terms" scoring concession for TRS arrangements.

Transitional arrangements until 30 June 2020

In a new section, Schedule 2 now recognizes that it may cause taxpayers to review their derivative financial arrangements. And consequently, some taxpayers may modify their arrangements to prospectively come within the green zone.

Until 30 June 2020, the ATO may consider remitting shortfall penalties to nil and the shortfall interest charge to the base rate if certain pre conditions are met. The conditions are that:

- Taxpayers make a voluntary disclosure in relation to all income years where their arrangements are in place.
- Adjust their historic and prospective derivative financial arrangements to come within the green zone.

Taxpayers may inform the ATO if they wish to transition their arrangements during or before a risk review, pre compliance review, justified trust review or any similar product, but not after any notification to the taxpayer of the commencement of formal audit activity.

Risk indicators

There are 14 specific risk indicators for cross-border related-party derivative arrangements used to hedge or manage the economic exposure of a company or group.

Where derivatives reflect terms that would be found in an equivalent arrangement between non related parties dealing at arm's length no risk score is added.

Each of the following criteria, if applicable to the taxpayer, adds to the risk score. In an outbound scenario factors (v) to (xiv) are weighted with 10 risk points each. In an inbound scenario factors (ix) – (xiv) carry 15 points each.

(i) Functional currency not used

(ii) There is no exposure to dealings with a non related party on commercial terms

(iii) There is a history of derivative transaction being terminated before maturity date

(iv) There are no periodic net cash flows

(v) **Not ultimately backed out to the market to a non related party to mirror the same terms**

(vi) There is only internal exposure

(vii) Results in an over hedge

(viii) Results in loss without corresponding gain

(ix) The transacting stand-alone legal entity is not also the entity entering into the derivative transaction

(x) The transacting entities entering into the derivative transaction lack financial substance

(xi) Hybrid mismatch entities are involved

(xii) Counterparty is in a low tax jurisdiction, favorably taxed, or in a tax loss position

(xiii) Terms would not be found in an equivalent arrangement between non related parties

(xiv) Partial or full synthetic sale of the underlying asset creates no gain for tax purposes

(emphasis added).

Where derivatives reflect terms that would be found in an equivalent arrangement between non related parties dealing at arm's length, no risk score is added under (xiii), but the derivative may still be classed as an elevated risk under other factors.

Risk of compliance activity

The green (low risk) zone stops at a total score of 4 points and the blue zone runs to a total score of 10 points. The higher risk zones start at 11 to 18 points (yellow) and up to 24 points (amber). A total score of merely 25 points or more results in a very high-risk rating (red zone).

Where a derivative has been entered into either directly or indirectly, via one or more interposed related parties, backed out to the external market to a non related party dealing at arm's length on exact mirror terms then the arrangement being scored will only be in either the low risk green or blue zone (this excludes TRS arrangements).

The risk zones are to assist in considering the risk of ATO compliance activity relating to:

- Deductibility of payments
- Liability to withholding tax
- Transfer pricing rules, including the reconstruction provisions
- Application of the general anti-avoidance rule (Part IVA of the ITAA 1936)

Taxpayers will be expected to self-assess the ATO perceived tax risk factors in relation to their related party derivatives – from green (low risk) to red (high risk).

Taxpayers filing the RTP Schedule will need to disclose their risk assessment as part of the questions under Category C of that schedule.

Ongoing concerns with Schedule 2

Based on our consultations with the ATO, Schedule 2 is framed by the "post BEPS transfer pricing world" approach which is to look to "the economic and financial conditions of the funding" or in other words gain clarity on the commercial rationale for "why the derivative needs to be there in the first place."

There continue to be concerns with Schedule 2 which is very broad in its application and does not take into account the business models for financial services participants that do not have an ADI in the group.

No additional carve outs for non-ADIs in financial services sector

Despite repeated requests from EY and industry, Schedule 2 contains no additional carve outs for financing or insurance entities and creates major compliance difficulties for non-ADI foreign banks, insurance companies, special purpose vehicles (SPV) and treasury centers ("non-ADI financial institutions"). Many banking and capital markets entities will be impacted as many broker/dealers typically do not have an ADI in the group.

Binary risk scoring without motivational factors

It is very easy for the risk scoring to classify entities in the red zone (high risk), due to multiple overlapping simultaneous indicators.

The overlapping risk factors cause false positives and high-risk scores. For example, if taxpayers can demonstrate that their derivatives are backed out on perfect mirror terms they do not incur any score at item (v) and are in green or blue zone. But if the terms are not a perfect mirror 10 points will be added to their tally before testing the next 9 items.

Schedule 2 has little regard to the concept in the PCG and Schedule 1, that taxpayer motivational factors are relevant in risk assessment in addition to pricing. For example, Schedule 2 has no scope for even minimal divergence of related-party derivatives in intermediary situations, consistent with appropriate arm's-length pricing.

Example 4 involves triple high scores for example indicating high risk, but there is insufficient attention to whether the relevant arrangements are on commercial terms. It shows a risk score of 65 points, where 25 points triggers a red zone classification. It is an example of an inbound US automotive company with an Australian subsidiary using cross-currency SWAPs (10 points are added for no backing out the swaps to market on mirror terms, 10 points for internal only, 15 points for the transacting party not being the one entering into the derivative, 15 points for a lack of financial substance in the entity entering into the derivative and 15 for hybridity in the structure).

Exact mirroring for back to back arrangements

Schedule 2 states that related-party derivatives will be high risk unless the terms and conditions of both sides of the arrangement mirror each other. This is problematical where treasury centers aim to reach an overall net hedge position but with different maturity dates and durations to enable efficient hedging of the risks.

The lack of a discussion about pricing and margins, appears to cause a distortion in relation to some of the examples and discussions about back to back arrangements. Example 3 starting above para 168 then infers that mirror means perfect mirror. The requirement to produce an exact mirror is an overreach as usually global terms would look to achieve a net hedge.

Next steps

It is important to note that a high-risk assessment result under the PCG represents an indication of the ATO perception of risk. As with the PCG, taxpayers in the red zone can expect significant ATO examination of their positions.

Affected taxpayers will need to consider how to factor Schedule 2 into their RTP disclosure obligations, compliance processes and engagement with the ATO.

Given these issues, and the limited time to transition into the green zone before 30 June 2020, affected taxpayers will need to act now.

Most affected taxpayers will already have considered their arrangements and related documentation, at least partially. That review needs to be concluded and action identified including consideration of any impact on prior year positions.

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