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Global Tax Alert

News from Transfer Pricing

Australian Taxation Office issues guidance on compliance approach to related party derivative arrangements and total return swaps, for tax returns and risk management

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On 27 November 2019, the Australian Taxation Office (ATO) issued in final "Related party derivative arrangements" (Schedule 2) to the "ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions" Practical Compliance Guide PCG 2017/4 (PCG) (ATO link) following the earlier draft issued in August 2018.

Schedule 2 still has effect from 1 January 2019: it applies to existing and newly created related-party derivative arrangements, and also total return swaps (whether or not with related parties). The PCG is 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 (high risk).

Importantly, taxpayers subject to the 2019 Reportable Tax Positions (RTP) disclosures must disclose their PCG risk classification. The PCG does not apply, broadly, to members of groups containing an Authorized Deposit-taking Institution (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.

All taxpayers subject to the PCG including banking and capital markets and insurance entities (which do not contain an ADI in the group) and financing entities are required by Schedule 2 to analyze and score:

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

Schedule 2 states that derivatives used for commercially rational hedging purposes are seen mostly with unrelated parties but if they occur with related parties they are likely to be considered as high risk unless they are backed out to the external market on mirror terms.

Schedule 2 provides guidance to assist taxpayers that may wish to transition their relevant derivatives into the green (low risk) zone including remission of shortfall penalties until 30 June 2020 under certain circumstances.

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. These risk indicators are provided 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 *Income Tax Assessment Act 1936*).

Taxpayers will be expected to self-assess the ATO perceived tax risk factors in relation to their related-party derivatives. Depending on the answers, risk assessments will range 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.

There continue to be concerns with Schedule 2, which is very broad in its application and:

- Contains no additional carve outs for entities such as financing or insurance entities.
- Has little regard to the concept, both 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.
- Makes it very easy for risk scoring to classify entities in the red zone (high risk), due to multiple overlapping simultaneous indicators. Examples include a risk score of 65 points, where 25 points triggers a red zone classification.
- Does not properly consider back to back arrangements and, in particular, pricing and margins. 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.

Next steps

It is important to note that a high risk assessment result under the draft PCG represents an indication of the ATO perception of risk and will not necessarily indicate that the transaction is not arm's length. However, 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 and compliance processes.

Given these issues, and the limited time to transition into the green (low risk) zone before 30 June 2020, affected taxpayers will need to take action now. Most affected taxpayers will have already considered their arrangements and related documentation, at least partially. Such reviews need to be concluded and action steps identified in light of any prior year positions.

Given the significance of Schedule 2 and its impact on a wide range of taxpayers, a detailed Alert will be forthcoming.

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