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Global Tax Alert

News from Transfer Pricing

Australian Taxation Office issues compliance guidelines for outbound interest-free related party loans

Executive summary

On 12 August 2020, the Australian Taxation Office (ATO) released long awaited draft guidance on outbound interest-free financing between cross-border related parties in Practical Compliance Guideline (PCG) 2017/4DC2. The draft guidance is added within a new schedule to PCG 2017/4 (the PCG); draft Schedule 3 (the draft Schedule).

The draft Schedule outlines the ATO's views on factors that may be considered to risk score an outbound interest-free loan arrangement, that otherwise would have been applied through the existing Schedule 1 (which addresses related party financing more generally) of the PCG.

As with the ATO's overall PCG framework, taxpayers are expected to "self-assess" their position in light of the guidance. The draft Schedule retains the same "risk zones" as Schedule 1 of the PCG, guiding the ATO treatment and level of expected compliance resource allocation. Further consistent with the ATO's view, the draft Schedule's starting point for an outbound interest-free loan arrangement is a presumption that the arrangement is high risk (amber risk zone) before consideration of any other characteristics of the financing arrangement. The ATO states in the draft Schedule that such arrangements present a "high" transfer pricing risk on the basis that "generally, loans are not provided by independent parties on an interest-free basis."

The draft Schedule provides the ability for taxpayers to move away from the high-risk zones of the PCG and lower the risk rating of their outbound interest-free loan arrangements, provided a taxpayer can evidence one of the following:

- The zero-interest rate is an arm's-length condition of the loan
- The loan is in substance an equity contribution
- Independent entities would have not entered into the actual loan and would have entered into an equity-funded arrangement

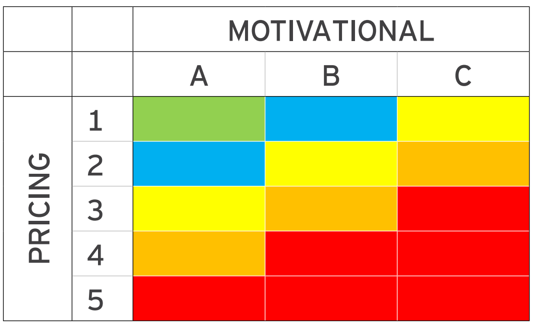
The draft Schedule provides a two-step approach in determining the risk scoring, considering initial "minimum required factors" that must be present to achieve any reduction in risk rating and subsequently a more detailed holistic consideration of the overall arrangements. Relevant considerations are to a large extent consistent with those historically identified for assessing "quasi-equity" type arrangements. However, taxpayers will be expected to conduct a detailed analysis within the framework of the transfer pricing legislation in Subdivision 815-B of the *Income Tax Assessment Act 1997* (ITAA 1997), including appropriate evidence upon which conclusions are based.

Detailed discussion

Risk zone scoring

The overall risk zone scoring outcomes in the draft Schedule are consistent with the guidance provided by existing Schedule 1 of the PCG. The colored risk zones are provided in the table below, with total scores from a "pricing" and "motivational" perspective contributing to the relevant position within the below matrix.

ATO's risk zone matrix – Paragraph 203 of the draft Schedule



The ATO asserts that, generally, loans are not provided by independent parties on an interest-free basis. Prior to the application of the guidance in draft Schedule 3, an interest-free outbound funding arrangement would automatically be allocated 10 points, resulting in a pricing score of 10 or more, regardless of other factors. This score would result in a pricing zone of 4 or 5 in the matrix above and therefore an automatic "amber" or "red" zone classification.

The expected ATO treatment/compliance activity of falling within each color zone is provided below.

ATO's compliance activity per risk zone (summarized and condensed) – Paragraph 41 of PCG 2017/4

Risk zone	ATO treatment
White	No review other than to confirm ongoing consistency with the agreed/determined approach
Green	...We will apply compliance resources to review your related party financing arrangement in exceptional circumstances ...
Blue	We will actively monitor your arrangements using available data and will review arrangements by exception Alternative dispute resolution (ADR) might be effective in resolving any areas of difference
Yellow	We will work with you to understand and resolve areas of difference ADR might be effective in resolving any areas of difference
Amber	Reviews are likely to be commenced as a matter of priority We will work with you to understand and resolve areas of difference ADR might be effective in resolving any areas of difference
Red	Reviews are likely to be commenced as a matter of priority Cases might proceed directly to audit You will not be eligible to access the APA program We are likely to use formal powers for information gathering Practically, it will be more difficult to resolve disputes through settlement or ADR You might face an increased prospect of litigation

Scoring modifications

The ability for the draft Schedule 3 to modify the application of Schedule 1 of the PCG is limited to the "pricing" risk scoring table factors only. For outbound loan arrangements, the relevant pricing scoring factors are as follows:

- Price relative to group cost of debt (traceable third party, relevant third party or all in cost of debt)
- Currency of the debt is not consistent with operating currency
- Sovereign risk of the borrower entity's jurisdiction

The motivational risk scoring table is not impacted by the draft Schedule and the analysis required for Schedule 1 continues to be applicable and required for a combined scoring outcome.

Price relative to group cost of debt

The ATO's starting point for outbound interest-free debt remains a pricing risk score factor of 10 points, consistent with Schedule 1. However, the taxpayer has an opportunity to self-assess a lower score, based on the relevant factors outlined in the draft Schedule 3.

Taxpayers now can lower this score by analyzing and documenting the arm's-length conditions to determine if an outbound interest-free loan is more akin to an issue of equity or the interest-free nature of the loan is arm's length.

The consideration of these factors is discussed further below.

Currency of the debt

The currency of the debt factor remains unchanged from Schedule 1.

It is key to note that this factor is altered slightly when considering inbound versus outbound financing. While the ATO expects inbound funding to be in the operating currency of the borrower, it relaxes this expectation on outbound funding in situations where the funding is not in the borrower's currency but is denominated in the Australian lender's accounting and tax functional currencies.

This demonstrates that the ATO is concerned with the foreign exchange impact on Australian taxpayers and views any potential foreign exchange impact to be worthy of a high-risk score. It is likely that the ATO will seek to review and may challenge any tax deductions claimed for foreign exchange losses arising from interest-free outbound funding to related parties.

Sovereign risk of the borrower

The ATO has modified the sovereign risk of the borrower factor by effectively reversing its view on outbound interest-free loan arrangements, as compared to Schedule 1.

The score applied for the credit rating of the jurisdiction of the borrower is displayed in the following table from the draft Schedule.

Draft Schedule pricing risk scoring table – sovereign risk – Paragraph 208 of the draft Schedule

Indicator	Outbound			Outbound & inbound
	Score			Score
	10	3	1	0
Sovereign risk of borrower entity	AAA, AA	A, BBB	BB	B, CCC

The table implies that the ATO considers outbound interest-free financing to be lower risk if the borrower is in a jurisdiction with a lower (i.e., worse) sovereign credit rating, or higher risk if the borrower is in a jurisdiction with a higher sovereign credit rating.

We have some concerns with this table for the draft Schedule, as it may result in an inappropriate risk score being allocated to funding provided to borrowers in jurisdictions with high sovereign ratings, despite the borrowing entity itself being in a position where it would have little prospect of raising interest bearing debt (e.g., a mining exploration subsidiary).

We will share our views with the ATO and work with them to consider whether other factors could be used to address their concerns, other than the sovereign risk rating. In our view, other factors could better allow the ATO to identify genuine risks.

Self-assessing a reduced pricing score

The draft Schedule broadly outlines three circumstances where an outbound interest-free loan arrangement may be acceptable under the transfer pricing rules.

These factors mirror elements of the transfer pricing "reconstruction provisions" in section 815-130 of the ITAA 1997 and effectively require a taxpayer to demonstrate either that:

- The interest-free funding is part of a broader arrangement which is consistent with "arm's-length conditions."

- The reconstruction provisions would apply to change the commercial or financial relations that are "priced" (i.e., to postulate a transaction that is not an interest-free loan but rather equity funding).

The three circumstances and our view on the overlap of section 815-130 are outlined as follows:

- Zero interest rate is an "arm's-length" condition of the loan (price consistent with the "basic rule" in section 815-130 requiring consideration of the actual commercial and financial arrangements).
- Although in the form of a loan, the "substance" of the lending arrangement is an investment of equity (subsection 815-130(2), which requires consideration of substance over form, where there is inconsistency between the two).
- Independent entities would not have entered into the actual loan and would have entered into an equity funding arrangement (subsection 815-130(3), which substitutes alternative arrangements in order to assess arm's-length conditions).

In evidencing that one of the scenarios above is applicable to a taxpayer's arrangement, the draft Schedule provides framing considerations and a two-step approach to be analyzed and documented.

It is important to note that as a starting point, the underlying legal agreement will be important to the analysis in terms of documenting the intention of the parties and should be carefully drafted/considered.

Framing considerations and two-step approach

The framing considerations and two-step approach involve a multitude of layers of factors and circumstances the ATO expects a taxpayer to consider and document in relation to the interest rate pricing risk factor. The draft Schedule factors draw on some of the factors in the historical guidance provided by Taxation Ruling TR 92/11, that was applicable to Division 13 of the *Income Tax Assessment Act 1936* (ITAA 1936).

Step 1 – Minimum required factors

If a taxpayer is able to answer "yes" to one of the alternatives in each of the questions below, the ATO will assign 3 points rather than 10 points for interest rate pricing (which may enable the taxpayer to move from an amber or red zone to a yellow or blue zone).

The alternatives are outlined in Paragraph 214 of the draft Schedule and are summarized below:

References within draft Schedule	Required factors
Paragraph 214(a)(i)	*Rights and obligations equivalent to that of a shareholder? (or the lender is the shareholder)*
Or	**Or**
Paragraph 214(a)(ii)	*No intention of creating a debtor-creditor relationship? (i.e. it's clear there is not an intention for there to be a loan)*
AND	**AND**
Paragraph 214(b)(i)	*Intention that funds would be repaid or interest imputed only at such time that the borrower is in a position to repay? (e.g. any repayment or return is contingent on profitability of the borrower)*
Or	**Or**
Paragraph 214(b)(ii)	*Borrower has questionable prospects for repayment and unable to borrow externally? (i.e. could not obtain a third-party loan)*

Step 1 – Evidence required

- In considering the intentions of the parties for the purposes of the two questions in Paragraph 214 (a)(ii) and 214 (b)(i), the Commissioner would have regard to the actual terms of the related party funding arrangement, as well as the broader context of the funding and business operations of the borrower. This may include consideration of factors such as:
- No date of repayment for interest or principal and no reasonable expectation of payment (e.g., a mining exploration project)
- Payments contingent on profitability of borrower
- Subordinated repayment rights

In substantiating an inability to borrow funds externally for the purposes of Paragraph 214(b)(ii), there is no bright line test, but the PCG does provide some relevant factors including:

- High debt/equity ratio compared to industry
- Inability to service debt

- Status of business operations of the borrower, e.g., a mining exploration company which is not in a position to provide security or service any debt, or a project which is still at a pre-final investment decision stage

Step 2 – Additional factors

Step 2 has a sequential application after Step 1 and does not operate in isolation. Step 2 allows taxpayers to potentially lower their interest rate pricing risk score calculated under Step 1 from 3 points to 0 points (which may enable the taxpayer to move into the green zone).

The draft Schedule adds Step 2 as requiring taxpayers to effectively test that the outbound interest-free loan arrangement is consistent with the arm's-length conditions and should be considered from both the borrower's and lender's perspectives.

An example provided by the ATO whereby no interest being charged on a loan would be consistent with arm's-length conditions without an effective "reconstruction" of the arrangement as equity funding is an offtake agreement where the benefit of interest is substituted for consideration of another form.

In the absence of evidence of a specific arrangement in which interest-free funding is an arm's-length condition, taxpayers effectively need to evidence that the funding arrangement is "in substance" equity funding, or commercial debt funding is not viable (such that funding could only have been sourced as shareholder equity funding).

Step 2 is intended to require a more comprehensive analysis than the initial response to Step 1 and lists out various factors that may be relevant considerations, including:

- Options realistically available to borrower and lender
- Whether the funding arrangement has a fixed repayment date and any associated terms (e.g., whether the funding is repayable on demand and any subordination)
- Regulatory restrictions on legal form equity/foreign ownership (often seen in mining), among others

The Commissioner acknowledges that funding provided will be accepted as low risk where the factors below are present:

- The funds are used to acquire capital assets used in the expansion of the core business and it is customary in the industry to enter into longer term investments.
- The borrower does not have the financial capability to repay the funds until it achieves a cashflow positive position over the longer term.
- It is unlikely funds could be secured externally.
- The purpose of the arrangement is consistent with the group's funding policies and practices.

The Commissioner notes that any analysis should consider the relevant circumstances at the time the funds were advanced, and the original "characterization" should not change over time, absent a material amendment to the arrangements.

This is helpful in providing taxpayers with certainty that existing interest-free arrangements will not be annually reassessed. However, taxpayers should be mindful that any subsequent inconsistent treatment (between transfer pricing and the broader income tax provisions) associated with the arrangement is likely to result in the Commissioner seeking to assess a transfer pricing benefit. An example is provided of seeking to claim a deduction for "commercial debt forgiveness" in relation to a funding arrangement effectively treated as equity for transfer pricing purposes.

Step 2 – Evidence required

The draft Schedule requires taxpayers to gather appropriate evidence to substantiate conclusions under Step 2, for example:

- Source documents such as:
  - Loan agreements
  - Treasury policies
  - Credit ratings
  - Financial accounts
- Financial evidence that the borrower is not in a position to repay the loan until project cash flows become positive
- Market/industry evidence on standard practices

Examples of draft Schedule application

There are four illustrative examples included in the Schedule, each of them highlighting issues associated with factors relevant to consideration of whether the underlying transaction should be evaluated as an equity contribution.

The four examples illustrate the application of the draft schedule to the subsidiary of an Australian company with operations involving:

1. Mining
2. Manufacturing
3. Infrastructure
4. Commercial property management

Reportable Tax Positions

When the draft Schedule is finalized, the risk zone self-assessed under the finalized schedule will be expected to be disclosed in the Reportable Tax Positions (RTP) Schedule, filed by some taxpayers with the corporate income tax return.

While the self-assessment under the PCG is not mandatory, if a taxpayer is unable to, or chooses not to, complete the self-assessment, this is required to be disclosed on the RTP.

While the RTP instructions relevant to the draft PCG Schedule 3 have not yet been released, we note that in relation to the RTP disclosures for Schedule 1 of the PCG, not completing the self-assessment is viewed by the ATO as akin to exhibiting characteristics of the high-risk zone as they are categorized within the same disclosure category.

This disclosure will further distinguish taxpayers that present a higher integrity risk from an ATO perspective and could conceivably hasten the ATO compliance action for certain taxpayers.

Interaction of the draft schedule with other relevant provisions/guidance

The draft Schedule is intended to read in conjunction with:

- Existing Schedule 1 of the PCG
- Taxation Ruling TR 2014/6 *Income tax: transfer pricing – the application of section 815-130 of the Income Tax Assessment Act 1997*
- Taxation Determination TD 2019/10 *Income Tax: can the debt and equity rules in Division 974 of the Income Tax Assessment Act 1997 limit the operation of the transfer pricing rules in Subdivision 815-B of the Income Tax Assessment Act 1997?*

The draft Schedule is explicit that the following provisions and guidance are not considered for the purposes of the draft Schedule:

- Debt/equity rules in Division 974 of the ITAA 1997
- Thin capitalization rules in Division 820 of the ITAA 1997
- Hybrid mismatch rules in Division 832 of the ITAA 1997
- Application of Part IVA (general anti-avoidance rule) of the ITAA 1936

However, the ATO expects that the arm's-length conditions that are taken to operate by virtue of the transfer pricing provisions should apply for "all income tax and withholding tax purposes" (i.e., where a different tax outcome results from applying other provisions assuming the arm's-length conditions, that a different tax outcome could be assessed as a transfer pricing benefit under Subdivision 815-B). This is consistent with statements contained in TD 2019/10.

Date of effect

The ATO has not provided a proposed date of effect within draft Schedule 3 and invites public comment on the proposed date of effect.

Consistent with the date of effect for Schedule 1 of the PCG, the date of effect for draft Schedule 3 is expected to be applied to existing and newly created outbound interest-free loan arrangements.

The ATO is expected to extend its view held within the draft Schedule to historical arrangements falling within Subdivision 815-B and it is therefore important that taxpayers review the requirements for both prospective and retrospective outbound interest-free loan arrangements.

Inbound financing

The draft Schedule does not provide guidance on the treatment of interest-free inbound financing arrangements (which may present a risk of interest withholding taxes being assessed under the provisions of Subdivision 815-B).

While we would expect that broadly consistent principles would apply to determine whether the interest-free nature of an inbound funding arrangement is appropriate, there are a number of additional complexities to inbound interest-free funding arrangements which in our view need to be addressed by the Commissioner.

Implications

Key takeaways from the release of the draft Schedule are:

1. The ATO's guidance acknowledges that outbound interest-free loan arrangements may be accepted to be consistent with arm's-length conditions for the purposes of Subdivision 815-B and provides a welcome framework for taxpayers to analyze and evidence positions.

   However, the guidance in the draft Schedule is potentially complex and subjective and places a significant focus on taxpayers being able to "evidence" their self-assessed position. Taxpayers will need to undertake significant analysis to move into the lower risk zones.

2. Taxpayers should carefully prepare/consider the legal agreement and prepare evidence of the intentions of the parties and relevant circumstances at the time funding arrangements are entered into. This evidence and subsequent positions adopted for tax purposes which relate to the funding arrangement are expected to be consistent.
3. The date of effect is not provided and is open to consultation. However, our expectation is the analytical approaches and level of evidence outlined in the draft Schedule are likely to be the ATO's expectation of analysis applied to prior years.

Consultation

EY will be involved in the consultation with the ATO regarding the practical application of the draft Schedule. In this regard, the ATO continues to encourage taxpayers to proactively engage with them to address specific application issues.
EY will work closely with taxpayers in these discussions to increase clarity on the ATO's expectations and we welcome your input.

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