

Australian Tax Office releases further guidance regarding Cross-Border Related Party Financing and the Diverted Profit Tax

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Executive summary

On 18 December 2017, the Australian Taxation Office (ATO) published the following documents:

- ▶ [Practical Compliance Guideline \(PCG 2017/4\)](#) (outlining the ATO compliance approach to cross-border related party financing arrangements)
- ▶ [Law Administration Practice Statement \(PSLA 2017/2\)](#) (outlining the ATO processes for initiating and implementing a Diverted Profits Tax (DPT) assessment)
- ▶ [Draft Law Companion Guideline \(LCG 2017/D7\)](#) (**for consultation** - containing the ATO guidance on the application of the DPT - **comments are due by 16 February 2018**).

This Alert summarizes the new guidance.

Detailed discussion

Cross-border related party financing

The PCG 2017/4 (PCG) outlining the ATO compliance approach to cross-border related party financing arrangements is a major document. It has been significantly revised since the initial draft release and consultations

with EY and other industry and professional stakeholders. Notwithstanding this, it remains the case that this document is an ATO risk assessment framework tool only and does not necessarily reflect the law.

The PCG's effective date (1 July 2017) remains in force but will apply to all related-party financing arrangements on issue from that date. This brings into question the treatment relating to the back years for financing arrangements entered pre 1 July 2017, all of which remain open owing to Division 13's lack of a limited amendment period and Division 815's seven year limited amendment period which only commenced in 2013.

The key takeaways from the revised PCG are:

1. The pricing of related-party financing should align with the commercial incentive of achieving the lowest possible "all-in cost" (interest plus guarantee fees, swap costs, etc.) to the borrower.
2. The cost of financing should align with the cost 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.
3. The changed scoring system (as outlined below) which has simplified the interpretation and calculation of a taxpayer's PCG 2017/4 score but has made it (even) easier for taxpayers to be rated "very high risk."
4. The PCG indirectly implements related-party financing documentation and expected reporting requirements (in addition to the current transfer pricing documentation obligations), which include:
 - a. Evidence of a taxpayers PCG 2017 analysis.
 - b. Supporting legal agreements.
 - c. Evidentiary information supporting the appropriateness of the terms and conditions of a taxpayer's related-party financing.
 - d. Evidence supporting the overall commerciality of the related party financing.

The PCG now breaks the previous one scoring matrix across two risk scoring tables:

- A "**pricing risk scoring table**" with indicators being:
 - Pricing relative to referable debt which is required to be linked to traceable third party debt, relevant third party debt of the group, or global group cost of funds evaluated in this order of priority (i.e., taxpayers do not have the option to apply the most favorable referable debt).

- The changed scoring system provides that an interest rate that exceeds 200 basis points over the parent company interest rate is now sufficient *of its own accord* to result in a "very high-risk" rating.
- Other features such as appropriate collateral, subordinated debt (including mezzanine debt), currency of debt is not consistent with operating currency, presence of exotic features or instruments and sovereign risk of the borrower entity can also increase the risk score. However, a significant positive change from the earlier scoring system is that features relevant to the loan but not priced into the interest rate will no longer be incorporated into the taxpayer's risk score.
- A "**motivational risk scoring table**" with indicators being leverage of borrower, interest coverage ratio, applicable tax rate of lender entity jurisdiction and financing involves an arrangement covered by a taxpayer alert or a hybrid arrangement.

The scoring results as before in a risk matrix outcome, which is anticipated to be disclosed by taxpayers to the ATO upon request (unless required to furnish and file a Reportable Tax Positions Schedule), with differential ATO compliance actions initiated depending on the risk score. Importantly, given the holistic approach taken to Advance Pricing Agreements (APAs) by the ATO, entry to the APA process (and confirmation from the ATO that they will not review financing with regard to the DPT) is only available for entities with related-party financing in the green zone. As before, taxpayers in the blue, yellow and amber zones may work with the ATO and/or seek alternative dispute resolution methods. Whereas, taxpayers in the red-zone are likely to be reviewed as a matter of priority, are likely to proceed directly to audit, have no access to the APA program and become an increased prospect for litigation.

Diverted Profits Tax

The Diverted Profits Tax (DPT) is expected to impact approximately 1,600 significant global entities (broadly entities with global turnover of AU\$1 billion or more).

The PSLA outlines the ATO processes and high level approvals required for issuing DPT assessments. As expected, the ATO will require the involvement of the ATO General Anti-Avoidance Rules (GAAR) Panel (similar to the Part IVA processes), which should provide some level of comfort to taxpayers.

The draft LCG provides further commentary on various DPT legislative mechanics including the interaction of the DPT with the thin capitalization rules and the determination of foreign tax liabilities for groups of entities. While the ATO has previously indicated that the DPT should generally only be applied as a last resort after the conclusion of traditional transfer pricing dispute resolution, the draft LCG is silent on this point.

An additional Practical Compliance Guideline (DPT PCG) is expected in 2018. This is anticipated to provide further practical guidance on the relative DPT risks associated with particular arrangements and the likelihood of ATO review, particularly with regard to the sufficient economic substance test. The DPT PCG will be subject to confidential consultation early in 2018.

ATO process for issuing DPT assessments (PSLA 2017/2)

An ATO officer must obtain approval from the ATO DPT specialist team prior to commencing a DPT analysis. Once approved, the ATO officer is required to engage with the Tax Counsel Network in undertaking the DPT analysis.

Other than in exceptional circumstances, the ATO protocols prior to issuing a DPT assessment include the following:

1. Obtaining endorsement from the DPT Review Committee.
2. A GAAR Panel initial hearing (with at least one non-ATO member but which excludes the taxpayer).
3. Deputy Commissioner endorsement on the decision to make a DPT assessment.

Where an ATO officer wishes to issue a DPT assessment contrary to the advice of the ATO GAAR Panel, additional internal consultation is required.

Once a DPT assessment has been issued, prior to the conclusion of the 12 month review period the matter must be referred to a GAAR Panel hearing at which the taxpayer may be invited to make written and oral submissions. On finalization of a DPT assessment the taxpayer's right of appeal will be to the Federal Court.

Next steps

Unfortunately, the ATO compliance approach remains challenging and intricate. Taxpayers who may be impacted by the DPT or PCG should review the latest materials provided by the ATO to identify potential impacts on structures and/or pricing, as well as the impact on financial reporting and audit processes.

The PCG relating to cross-border related-party financing arrangements will require detailed analysis for inbound and outbound groups including to:

- ▶ Consider their risk classifications under the PCG.
- ▶ Identify the accounting and financial disclosure implications (including the provision for any uncertain tax positions or reportable tax positions) as well as internal governance processes.
- ▶ Consider what action will be required, including potential adjustment of certain related-party financing, approaching the ATO to explain the appropriateness of current arrangements or to consider the transitional arrangements.

The PCG states that to encourage willing and co-operative future compliance, for a limited period, the Commissioner is willing to settle penalties and interest if taxpayers make a voluntary disclosure in relation to the back years and adjust historic and prospective pricing or level of debt to come within the green zone. The Commissioner's undertaking will remain in place for 18 months from the publication of the PCG or the effective date for any schedule to it. The PCG outlines the process for taxpayers wishing to take up the transitional proposal. Given the significant risk in relation to open back years, taxpayers will need to carefully consider whether to take advantage of these transition provisions.

A detailed Tax Alert on the final PCG will be forthcoming.

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EYG no. 07169-171Gbl

1508-1600216 NY
ED None

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