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Global Tax Alert

News from Transfer Pricing

Australian Taxation Office issues guidance on compliance approach to transfer pricing issues for nonresident owned mobile offshore drilling units

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On 26 September 2019, the Australian Taxation Office (ATO) released draft PCG 2019/D5 (the draft PCG), which outlines their compliance approach in relation to transfer pricing issues for projects involving the use in Australian waters of nonresident owned mobile offshore drilling units such as drill-ships, drilling rigs, pipe-laying vessels and heavy-lift vessels.

The draft PCG is intended to apply to both assets that are leased into Australia and assets that are operated in Australia by a nonresident owner. Its application is limited to assets classified as "mobile offshore drilling units" (MODU) and specifically excludes oil and gas production platforms, cable laying vessels and port works, such as dredging and rock dumping. It also does not apply to broader marine services operations, such as platform supply vessels, seismic survey vessels or bulk carriers. However, based on experience and informal discussions with the ATO, it is expected that the approach used in the draft PCG will be broadly replicated when considering the application of Australian tax law to such assets.

Consistent with other previously released PCGs, the draft PCG outlines a risk framework made up of four risk zones, consisting of:

- White zone (self-assessment not required as the ATO has already reviewed the arrangements)
- Green zone (low risk)

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- Amber zone (moderate risk)
- Red zone (high risk)

Arrangements will be classified within the white zone where an advance pricing agreement (APA) applies to the relevant income year, there is a formal settlement agreement with the ATO applicable to the year, or the ATO has conducted a review of the activities (within the last two years) and provided a "low risk" rating.

Classification within the green to red zones is dependent upon the level of operating profits realized in Australia and the materiality of the contract/project revenues:

- Where the Australian operations realize an operating margin in excess of 10.5%, the arrangements will be classified in the green zone.
- Where the Australian operations realize an operating margin between 5% – 10.5%, or the operating margin is less than 5%, but total revenues in the income year from all Australian contracts or projects is less than AU$20 million, the arrangements will be classified in the amber zone.
- All other operations will be classified in the red zone (i.e., where operating margin is less than 5% and the revenues are greater than AU$20 million).

Where operations in Australia are conducted through more than one entity, the risk framework in the PCG is intended to apply to the entirety of activities performed in Australia and it may be necessarily to aggregate the financial outcomes of such entities in order to apply the framework.

Consequently, the margins earned by any separate Australian operations which undertake procurement, engineering, project management, crewing or other activities in support of the main operating entity in Australia will need to be incorporated in assessing risk outcomes (as well as revenues, if a separate payment is made by the third-party customer to those entities).

The ATO will treat arrangements within the green zone as being at a lower risk of not complying with the Australian transfer pricing rules and the ATO will not generally seek to conduct compliance reviews of these arrangements (other than to confirm certain facts and verify that arrangements fall within the green zone).

Taxpayers with arrangements falling within the green zone will also be eligible to adopt a "simplified transfer pricing record keeping option," to minimize transfer pricing record keeping and compliance costs. However, the draft PCG cautions that the low risk zone is not a safe harbor and as such, taxpayers are still required to self-assess the arm's-length conditions associated with the arrangements. Falling within the low risk zone does not automatically mean that transfer pricing outcomes are correct and conversely falling outside of the low risk zone does not imply that the transfer pricing arrangements are incorrect.

While the draft PCG does not provide any technical guidance on the ATO's approach to transfer pricing arrangements, it does outline the depth of documentary evidence which will be requested by the ATO in the event of a review, which may include:

- Customer contracts, invoices and tender documentation
- Financial statements of all entities involved in the arrangements, including offshore related parties
- Organizational charts, qualifications, remuneration and names of key operating personnel
- Project reports, plans and budgets
- Vessel/rig details, including construction costs and dates of activities in Australian waters
- Vessel/rig owner's fixed asset schedule
- Vessel market valuations
- Details of any debt financing relating to a vessel or rig operated in Australia, including any projections provided to the financier

Taxpayers should be mindful of the documentation expected to be provided in the event of a review and when outside of the low risk zone, consider whether transfer pricing compliance documentation should incorporate or cross reference the items listed above.

Notwithstanding the criteria for the risk zones outlined in the draft PCG, in the event of a review, the ATO will seek to review not only the net profits of the Australian operations, but also the appropriateness of any returns earned by offshore related parties involved in the projects. This "top down" approach is consistent with the ATO's current approach to transfer pricing in audits and reviews of taxpayers in the oil and gas services sector.

Taxpayers should therefore ensure that their transfer pricing documentation analyzes the returns of any offshore related parties involved in either the provision of the mobile assets, or other activities associated with the projects.

Implications

- The draft PCG is proposed to apply both before and after its date of issue and taxpayers may be required to report their risk zone in future Reportable Tax Position schedules.
- Where assets utilized within Australia fall within the definition of "mobile offshore drilling units," taxpayers should review the anticipated risk zone rating. Where arrangements do not fall within the white or low risk zone, taxpayers should review their transfer pricing arrangements to ensure a robust policy has been adopted and/or consider an application for an APA.
- It is recognized that in the current economic environment, many arrangements to which the draft PCG applies will fall outside of the low risk zone, despite an appropriate and sustainable transfer pricing policy having been adopted.
- While other non-MODU vessel operations in Australia fall outside of the risk framework in the draft PCG, the parameters of the risk zones may still provide a broad indication of how the ATO would view such arrangements. It is anticipated that broader vessel operations will remain a focus area of the ATO and detailed transfer pricing documentation should be prepared annually to support pricing policies applied.
- In the event of a review, the ATO is likely to request significant documentary evidence regarding vessels or rigs operating in Australia, the associated customer projects and profitability of any offshore entities involved in the projects.

Next steps

EY is continuing to consult with the ATO in relation to the transfer pricing issues relevant to all nonresident owned assets utilized in Australia. Comments on the draft PCG can be submitted until 25 October 2019. We welcome input from taxpayers for inclusion in our submission.

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