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# ***New ATO Guidance on Cross-Border Related Party Financing***

*30 May 2017*

## ***In brief***

The Australian Taxation Office (ATO) has publicly made it very clear that there is intense focus on cross border related party financing arrangements. Multinational taxpayers will now have more information to self-check because of the ATO's assessment of tax risks associated with related party financing arrangements. This new ATO guidance has been released in the form of a Practical Compliance Guideline that will take effect from 1 July 2017 and applies to old and new financing arrangements entered into with a foreign related-party

Last month, the Full Federal Court handed down its decision in Chevron Australia, upholding the earlier Federal Court decision to disallow excess interest deductions in respect of the intra group debt that Chevron Australia paid to Chevron group's US finance company at an interest rate of around 9%. This is the first precedent that the significant amount of interest deduction was disallowed from an Australian Transfer Pricing perspective, which resulted in the additional tax of approximately A\$ 340 million to be imposed. For Multinational taxpayers, this precedent may affect pre-existing and new financial arrangements with a foreign related party. It is obvious that the Guideline has been issued by the ATO also taking into consideration the Full Federal Court's decision.

The Guideline sets out a multifaceted framework for how the ATO differentiates risk (risk zones) and how it tailors its compliance approach according to the features of the related party financing arrangement. If your related party financing arrangement falls outside the low risk category, you can expect the Commissioner of Taxation will monitor, test and/or verify the tax outcomes of your related party financing arrangement. The higher the risk rating, the more likely an arrangement will be subject to specific ATO review and scrutiny.

## ***In detail***

On 16 May 2017, the ATO issued for public comment draft Practical Compliance Guideline 2017/D4 which sets out the ATO's compliance approach to the taxation outcomes associated with an inbound and outbound "financing arrangements" and related transactions or contracts, entered into with a cross-border related party. Specifically, the framework set out in the draft Guideline is aimed to assist taxpayers:

- assess the tax risk of a related party financing arrangement in accordance with the ATO's risk framework, and
- understand the compliance approach the Commissioner is likely to adopt given the risk profile of a related party financing arrangement.

The purpose of the Guideline is to give taxpayer's confidence that if their circumstances align with the "low risk category", the ATO will generally not allocate compliance resources to test the relevant tax outcomes of the related party financing arrangement. Accordingly, it is fair to say that taxpayers are effectively put on notice to review existing financing arrangements and where necessary, potentially amend prior year returns to reflect adjusted pricing or levels of debt of financing arrangements.



**How to assess risk on a related party financing arrangement?**

The draft Guideline sets out the risk indicators and risk assessment framework that consists of **11 ‘categories’** and **38 ‘zones’** for cross-border related party debt funding. In addition, the draft Guideline indicates that the Commissioner’s compliance approach will vary depending on “**score**” of the related party financing arrangement.

(Table 1 - Risk indicators and risk assessment framework of the Guideline)

Score	Outbound			Outbound & Inbound	Inbound			
	10	3	1	0	1	3	10	15
Price relative to: - global group cost of debt - traceable third party debt - relevant third party debt of borrowing tax entity	No interest charged	Less than the cost of referable debt		Inbound: 50 bps over cost of referable debt (or less) Outbound: Cost of referable debt or higher	51 to 100 bps over cost of referable debt	101 to 150 bps over cost of referable debt	150 to 200 bps over cost of referable debt	More than 201 bps over cost of referable debt
Leverage of borrower				Consistent with global consolidated leverage	Greater than global leverage but less than 60% leverage		More than 60% leverage	
Interest coverage ratio				Consistent with global consolidated group	Lower than global consolidated group ratio but equal to or greater than 10	3.3 to 9.9	Below 3.3	
Appropriate collateral				Yes		No		
Subordinated or mezzanine debt				No		Yes		
Headline tax rate of lender entity jurisdiction				Over 30%, or lender entity is global parent	21% to 29%	16% to 20%	1% to 15%	0%
Currency of debt is different to operating currency	Yes			No			Yes	
Involves an arrangement covered by a taxpayer alert	Yes			No			Yes	
At least one party is a hybrid entity	Yes			No				Yes
Presence of exotic features on loan				No			Yes	
Sovereign risk of borrower entity	B, CCC	BB	A, BBB	AAA, AA				

The purpose of the risk indicators and risk assessment framework is to give taxpayers an opportunity to evaluate the “score” of their funding arrangements with reference to a number of specific factors indicated in the Guideline so that taxpayers will have an overall risk assessment number that informs how the ATO plans to differentiate risks and tailor their approach to taxpayers. The risk zone and ATO’s approach are made up of six color-coded risk zones.

(Table 2 - Risk zones and ATO compliance action in the Guideline)

Score	Risk zone	ATO compliance action
Not applicable	Risk not applicable	Arrangements have already been reviewed and concluded by either the ATO or a court. No further review to be conducted by the ATO.
0 to 4	Low risk	The ATO will “ <i>generally</i> ” not apply compliance resources to examine the tax outcomes associated with related-party financing arrangements.
5 to 10	Low to moderate	The ATO will actively monitor your arrangements using data and exceptions based testing. ADR is available to resolve areas of difference.
11 to 18	Moderate risk	The ATO will “ <i>work with you</i> ” to understand and resolve “ <i>areas of difference</i> ”. ADR is available.
19 to 24	High risk	Expect reviews to commence as a matter of ATO priority. The ATO will “ <i>work with you</i> ” to understand and resolve “ <i>areas of difference</i> ”. ADR is available.
25 or more	Very high risk	Expect reviews to commence as a matter of ATO priority. Cases could proceed directly to audit, with use of their formal powers of information gathering. No access to APA programs, ADR will be “ <i>difficult</i> ”, and there is an increased prospect of litigation.

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### ***What are taxpayers expected to do?***

The ATO expects that taxpayers will need to test each financing arrangement entered into with a related party that is not a resident of Australia at the start of each income year and, where a financing arrangement is entered into during an income year, at the time it is entered into. The risk rating (i.e. score) for a related party financing arrangement will need to be tested using the method set out in the schedule to the Guideline. It may be also imperative that taxpayers document their self-assessment of risk for a related party financing arrangement. It is clearly stated in the draft Guideline that a taxpayer who is unable to provide evidence to support their risk assessment, might be subject to further ATO compliance activity.

In relation to prior income years, the Commissioner has given an undertaking that remits penalties on any shortfall (to nil) and shortfall interest charges to the base rate for 18 months from 16 May 2017 (i.e. the date of issue of the draft Guideline) or the effective date for any new schedule issued to this draft Guideline in the event that the taxpayer makes a full and true voluntary disclosure and certain conditions are met.

### ***ATO to continuously review its guidelines***

The use and application of the ATO's Guideline will be under continuous ATO review over the next three years. This means that additional schedules may be included in the future to provide specific risk indicators for particular types of entities or other financing arrangements, such as financial guarantees, interest free loans and related party derivative arrangements.

### ***Takeaway***

Given the ATO's movement in respect of related party financing arrangements, it may be prudent for Japanese Multinational to undertake a risk assessment analysis for each financial arrangement with a foreign related party in accordance with the Guideline so as to have a prospect of the future ATO's approach to your intra group debt finance. If the score derived from the analysis falls outside the low risk category, you may be subject to the monitoring by the Commissioner of Taxation. Further, provided that that score falls into high risk category or more, it is advisable to consider whether or not to take a certain appropriate action such as amendment of tax return or remediation of levels of debt of financing arrangements.

The self-review is still recommended despite Japan's corporate income tax rate being relatively similar to Australia's current company tax rate of 30%.

The self-review should also be performed in a manner consistent with an appropriate tax governance framework that should also be developed by and for the Australian subsidiary (ies) of Japanese multinationals.

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