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Tax Insights

ATO guidance on non-resident owned mobile offshore drilling units in Australian waters

Snapshot

On 26 September 2019, the Australia Taxation Office (ATO) released a draft Practical Compliance Guideline (PCG 2019/D5) on its compliance approach for offshore drilling and associated activities. Specifically, this guideline relates to 'transfer pricing issues involving the use in Australian waters of non-resident owned mobile offshore drilling units (MODUs)'. When finalised, this draft guideline is proposed to apply both *before and after* its issue.

The draft PCG follows Taxpayer Alert TA 2016/4 (published in April 2016), where the ATO expressed concerns about whether the amount brought to tax in relation to various cross-border leasing arrangements involving mobile assets is consistent with the contribution made by the Australian operations.

Similar to other PCGs, PCG 2019/D5 provides a risk assessment framework that outlines the ATO's compliance approach to the transfer pricing issues. The draft deals with the use in Australian waters of non-resident owned MODUs, with criteria for the classification of taxpayers with certain 'risk zones', along with the consequences of falling within a particular risk zone. Disclosure to the ATO of the self-assessed risk zone may be required in the Reportable Tax Position schedule (or at the ATO request).

Who does this guideline apply to?

This guideline addresses the transfer pricing issues related to the use of these assets in Australian waters by the 'operator' of the asset, whether an Australian tax resident or non-resident entity with a permanent establishment in Australia. Activities associated with offshore drilling could include input to attract and engage customers, secure contracts, project management, engineering, design, procurement, construction technology, health, safety and regulations, maintenance and vessel repairs, crewing services or office support.

Per the guideline, MODUs include drill-ships, drilling rigs (including but not limited to submersibles, semi-submersible and jack-up rigs), pipe-laying vessels and heavy-lift vessels.

This guideline does not apply to:

- oil and gas production platforms, which are not engaged in any drilling activities and are permanently anchored to the ocean floor
- cable-laying vessels which lay telecommunications and electric power transmission systems, operating in a different industrial context, under quite different technical and regulatory conditions, risks and economic circumstances
- port works, such as hard-stand construction, dredging, rock-dumping, reclamation and associated activities, which involve quite different technical and regulatory conditions, risks and economic circumstances, or
- tax risks other than tax transfer pricing risk.

Nor does the guideline apply if the substance of the arrangements differs from their legal form.

PCG Risk Zones

The ATO has constructed four risk zones which are summarised below. It does not necessarily follow that having a low risk rating under this guideline means that a taxpayer's transfer pricing outcomes are correct or that they have a reasonably arguable position. Equally, having a high risk rating under this guideline does not necessarily mean that a taxpayer's offshore drilling and associated activities fail to comply with Australia's transfer pricing rules.

White Zone

Entities will be deemed as being within the white zone if they have an APA in respect of their arrangement, agreed ATO settlement or where the ATO has assessed the arrangement as low risk after this guideline has come into effect.

In assessing the compliance risk in relation to the other risk zones, the level of profitability of the Australian operations and materiality of contract or project revenue are considered. References here are intended to refer to the entirety of the offshore drilling and associated activities of the operator in Australia, and to amounts resulting from those activities.

Green Zone – Low Risk

- Entities will be deemed as being low risk if the EBIT margin is greater than 10.5% in the relevant income year. Relevantly, EBIT margin means earnings before interest and tax arising from the Australian operations divided by the total contract revenue of the Australian operations

Amber Zone – Moderate Risk

- Entities will be deemed as being moderate risk if the EBIT margin is less than 10.5% but greater than 5% in the relevant income year, or
- If the EBIT margin is 5% or less but the total revenue from all the Australian contracts or projects is less than AU$20million.

Red Zone – High Risk

- Entities will be deemed as being high risk if the EBIT margin is 5% or less in the relevant income year (and the total Australian contract revenue exceeds AU$20million).

Resulting ATO activity from risk zone

The higher the risk rating, the more likely the arrangements will be reviewed by the ATO as a matter of priority. The resulting ATO activities depending on the risk zone classification are summarised below:

Risk Zone	ATO treatment
White	The risk assessment framework does not need to be applied but ATO activity will be dependent on the particular taxpayer circumstances, e.g. if under an APA, an annual compliance review process will apply.
Green	The ATO will generally not apply compliance resources to the arrangement. Taxpayers will be eligible to access the simplified transfer pricing record-keeping (STPRK) option (it is not yet clear how this will be applied, since the current PCG on STPRK does not allow for application to these arrangements)
Amber or Red	Being outside the low risk zone means that the ATO considers that a taxpayer is at risk of obtaining a transfer pricing benefit. The ATO will prioritise compliance resources to deal with taxpayers involved in offshore drilling and associated activities that are assessed as having the highest risk of obtaining a transfer pricing benefit. Compliance approaches may include monitoring, risk reviews and audits. There is a clear statement that taxpayers within the high risk zones will not be precluded from entering the APA program, but a greater level of transfer pricing documentation and evidence will be expected.

In addition, the draft PCG indicates that remission of penalties and interest may be available to taxpayers that engage with the ATO to transition their arrangements to the green zone, through voluntary disclosures, within a period of 12 months from the publication of the PCG.

Initial observations

Concerns regarding the ATO approach in this draft PCG include:

- Lack of transparency on the basis for the ATO-determined EBIT margins ('profit markers') for the particular risk zones
- The rationale for the choice of an EBIT margin as an appropriate 'profit marker' / 'quasi-benchmark' for an operator of a MOBU (noting that for offshore arrangements such as marketing hubs, a 'cost plus' ratio is used in the relevant PCG)

There are positives to be taken from this draft in that the ATO has applied a 'de-minimis' level (i.e. the AU$20million revenue threshold) to a taxpayer's Australian operations, albeit this would only move a taxpayer to the moderate risk zone. However, given the value of the assets covered by the draft PCG and the substantial commercial day rates charged for their use, it is likely that this threshold will only be applicable in limited circumstances.

An additional improvement from prior PCGs is that, notwithstanding the risk rating, all taxpayers remain eligible for the APA program.

Taxpayers should be aware that the issues in this industry are complex and advice should always be sought before commencing or changing any arrangements.

Finally, it should be remembered that PCGs are not an interpretive view of the law, the prescribed EBIT margins are not safe harbour administrative concessions or profit expectations. Rather they are simply elements of an ATO risk assessment framework. Moreover, taxpayers may take positions contrary to the draft PCG, provided they are supported by appropriate transfer pricing analysis and documentation.

Next steps

Comments on the draft PCG are due by 25 October with the guidance likely to be finalised shortly thereafter.

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