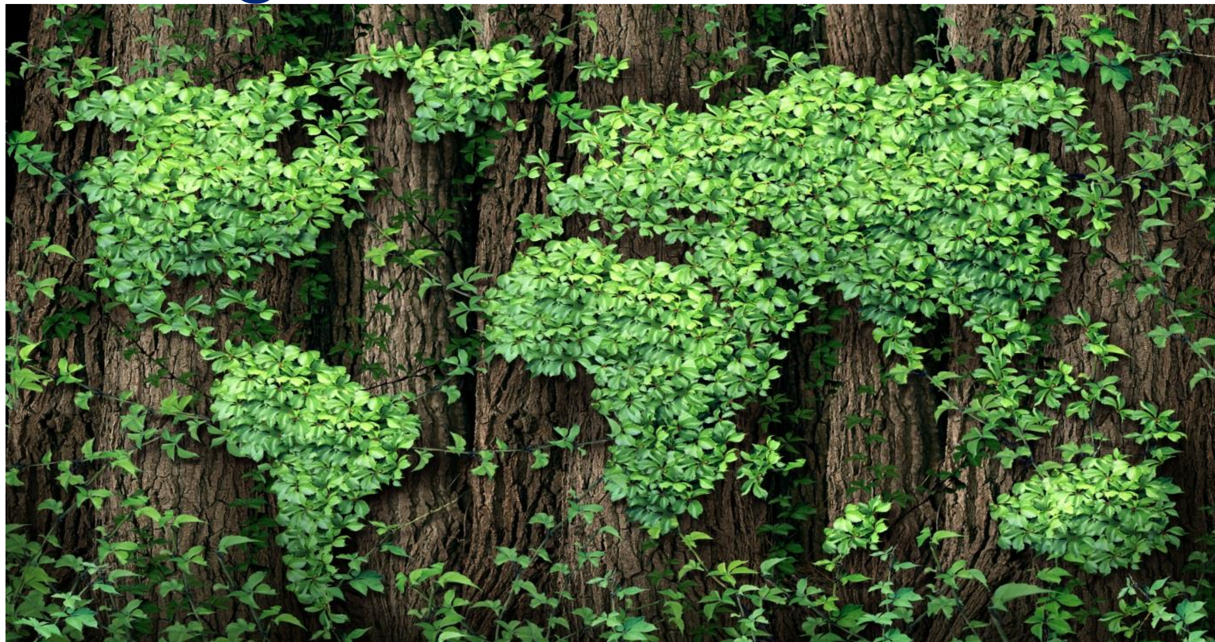
Deloitte.

29 April 2016
2016/04 Australia

Tax insights
ATO targets international profit-shifting arrangements



Snapshot

The Australian Taxation Office (ATO) released four Taxpayer Alerts on 26 April 2016 as a result of the ATO actively reviewing certain arrangements used by multinationals and large companies operating in Australia.

The four Taxpayer Alerts address the following:

- TA 2016/1: Inappropriate recognition of internally generated intangible assets and revaluation of intangible assets for thin capitalisation purposes
- TA 2016/2: Interim arrangements in response to the Multinational Anti-Avoidance Law (MAAL)
- TA 2016/3: Arrangements involving related party foreign currency denominated finance with related party cross currency interest rate swaps
- TA 2016/4: Cross-border leasing arrangements involving mobile assets

A summary of the ATO Taxpayer Alerts follows.

A Taxpayer Alert provides a summary of ATO concerns about a significant, emerging or recurring higher risk tax issue. The Alerts are intended to provide an "early warning" to taxpayers and advisers.

Multinational Anti-Avoidance Law

The Multinational Anti-Avoidance Law (MAAL) was enacted with effect from 1 January 2016 to broadly target certain cases where there has been an avoidance of permanent establishment (PE) status by a foreign entity, the foreign entity makes supplies to Australian customers and there is a relevant "principal purpose" to obtain a tax advantage.

Many taxpayers are currently restructuring into MAAL-compliant arrangements and .the ATO has raised concerns about two particular forms of arrangement which it sees as being "artificial and contrived" rather than "commercially and economically realistic". The two arrangements identified by the ATO are broadly as follows:

- **Offshore agent for Australian entity**: One such scheme involves the foreign and Australian entities "swapping their roles via contracts". These contracts purport to make the Australian entity the distributor of the products or services to Australian customers, and the foreign entity acts as an agent (disclosed or undisclosed) of the Australian entity, collecting the sales revenue from Australian customers on behalf of the Australian entity. The ATO considers that this contractual arrangement occurs despite no changes being made to the underlying functions performed by the entities. This arrangement purports to result in no supply being made by the foreign entity and, potentially, the foreign entity becoming a PE of the Australian entity in the foreign entity's jurisdiction.
- **Royalty payment restructured to a distribution fee**: The other arrangement deals with upstream aspects of the supply chain. Where a foreign entity makes supplies to Australian customers, and pays a royalty connected to such transactions, the application of the MAAL may result in the royalty being subject to Australian withholding tax. The ATO is concerned by some restructuring of the arrangements, such that the royalty is re-characterised as a distribution fee, which is arguably not subject to Australian withholding tax.

The ATO indicates that it has a range of potential concerns regarding both arrangements including that the arrangements may not be legally effective or commercially viable. A range of measures could potentially be applied to challenge the arrangements including the general anti-avoidance rules (GAAR) and the transfer pricing rules. The ATO states that taxpayers and advisors who put forward these types of arrangements will be subject to increased scrutiny.

Financing arrangements

There are two separate Taxpayer Alerts that address financing arrangements, one dealing with the Australian thin capitalisation rules and the other dealing with related party foreign currency loans, in conjunction with related party cross currency interest rate swaps

Thin capitalisation

Australia's thin capitalisation rules permit a general safe harbour debt amount of up to 60% of the value of a taxpayer's Australian assets (net of non-debt liabilities). The relevant asset values are typically taken from a taxpayer's financial statements. However, the thin capitalisation provisions permit taxpayers to do the following:

- **Recognition**: recognise certain intangible assets, where such an asset would not otherwise be recognisable under applicable accounting standards; and
- **Revaluation**: revalue certain intangible assets in circumstances where such an asset would not otherwise qualify for revaluation under applicable accounting standards

In both cases, the result is that the asset value can be increased, thus increasing the thin capitalisation safe harbour amount.

The ATO indicates that it has number of concerns including that certain items that are being recognised fall outside the scope of the intangible asset recognition criteria under applicable accounting standards. From ATO compliance activities, the ATO is concerned by items such as:

- market related items such as 'customer relationships' or 'customer loyalty';

- human resource items, including 'skilled staff', 'management' or 'key employees/training';
- organisational resource items, including 'internal policies', 'internal meeting protocols', 'procedures' and 'manuals'; and
- assets not owned and controlled by the taxpayer.

In addition, the ATO is concerned that taxpayers may be applying unsupportable or questionable assumptions to underpin the revaluations.

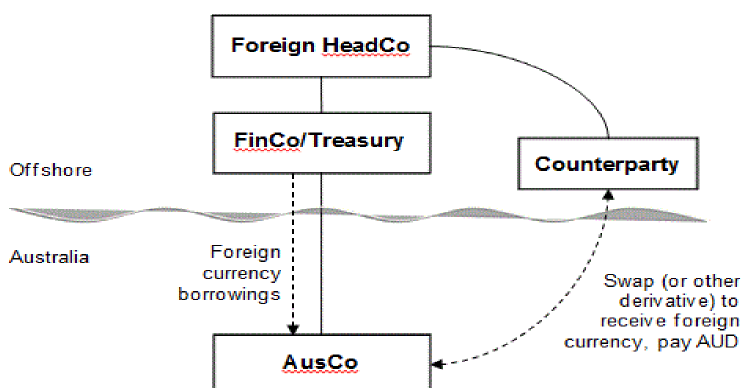
The ATO has obtained external advice on the application of relevant accounting standards and is considering its ability to substitute alternative asset valuations. Further accounting and legal guidance is expected from the ATO.

Related party cross currency interest rate swaps

The Taxpayer Alert outlines the following arrangement:

- An Australian entity borrows from offshore in a “low interest rate currency”, being a currency other than AUD
- The Australian entity enters into a swap or other derivative with an offshore related party under which the Australian entity is required to pay a “higher interest rate currency” (eg, AUD) and entitled to receive foreign currency, being the currency in which the loan is denominated.
- Where there is a net payment by the Australian entity under the swap or other derivative, these payments represent additional financing costs which are not in the legal form of interest.

The arrangement is depicted in the Taxpayer Alert as follows:



The ATO notes that some taxpayers assert that these arrangements have been entered into for accounting or ease of capital extraction purposes. The ATO is concerned that these arrangements achieve contrived thin capitalisation, withholding tax and transfer pricing outcomes. In particular, the ATO sees that the funding may have been implemented in an excessively complex manner for Australian tax purposes, rather than in a simpler manner more appropriate in the circumstances, such as funding by AUD loans, foreign currency loans (without swaps) or equity inclusive funding.

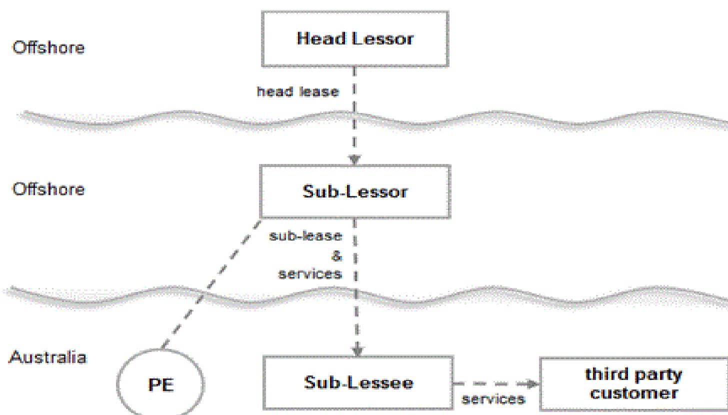
The ATO considers that such arrangements may be open to challenge in various respects including whether the swap / derivative payments are deductible, whether the transfer pricing rules may operate to adjust the tax outcomes and whether the GAAR may apply. Further details are expected to be issued by the ATO as it continues to develop its technical position.

Cross-border leasing involving mobile assets

The ATO is focussing on lease-in lease-out (LILO) arrangements involving:

- A Head lessor owns substantial equipment and leases it to a related foreign party, Sub-Lessor, who sub-leases the asset to a related Australian party, Sub-Lessee
- The Australian Sub-Lessee provides services to an Australian customer
- The Sub-Lessor has a PE in Australia under the relevant treaty

An example of a LILO arrangement in the Taxpayer Alert is depicted as follows:



The ATO is concerned that the Sub-Lessor may have been introduced to obtain favourable tax treaty benefits which may be subject to challenge under the GAAR, and further whether the transfer pricing rules are being appropriately applied to achieve an arm's length return to the Australian tax system. The ATO will issue guidance on transfer pricing and profit attribution issues associated with certain cross-border leasing arrangements

What should taxpayers do?

These Taxpayer Alerts reflect general views of the ATO in connection with arrangements which necessarily involve complex facts and deal with complicated areas of the tax law. Nonetheless, the direction of the ATO is clear in identifying such arrangements as significant, emerging or recurring higher risk tax issues. Taxpayers who have entered into those or similar arrangements should contact their Deloitte tax adviser or one of the Deloitte contacts.

Contacts

For more information, please contact

Vik Khanna
Partner
+61 (3) 9671 6666
vkhanna@deloitte.com.au

Mark Hadassin
Partner
+61 (2) 9322 5807
mhadassin@deloitte.com.au

David Watkins
Partner
+61 (2) 9322 7521
dwatkins@deloitte.com.au

Scott Bailey
Partner
+61 (2) 9322 7171
scbailey@deloitte.com.au

Claudio Cimetta
Partner
+61 (3) 9671 7601
ccimetta@deloitte.com.au

Jonathan Hill
New York
+1 7185 086 805
jonhill@deloitte.com.au

For further information, visit our website at www.deloitte.com

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the "Deloitte Network") is, by means of this publication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte has in the region of 225,000 professionals, all committed to becoming the standard of excellence.

About Deloitte Australia

In Australia, the member firm is the Australian partnership of Deloitte Touche Tohmatsu. As one of Australia's leading professional services firms. Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, and financial advisory services through approximately 6,000 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit our web site at www.deloitte.com.au.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Touche Tohmatsu Limited

© 2016 Deloitte Tax Services Pty Ltd.