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16 May 2017
Australia 2017/09

Tax Insights

Risk assessment framework for related party financing

Snapshot

On 16 May 2017, the ATO released the draft Practical Compliance Guide PCG 2017/D4 (the PCG), which outlines the ATO's risk assessment framework for related party financing arrangements.

Although this PCG has been anticipated for some time, it would seem that the release of this framework was timed to follow the decision in favour of the ATO in the recent Full Federal Court case involving Chevron. The PCG has been issued in the context that inbound loans to Australian taxpayers exceed AUD 400 billion, and the ATO is concerned that even small shifts in pricing can have significant impacts on the tax system.

The PCG sets out how the ATO will assess compliance risk attaching to cross-border related party financing arrangements and invites companies to self-assess their compliance risk. If considered necessary, companies are welcome, and in fact encouraged, to discuss the issue with the ATO for the purpose of mitigating any actual or perceived risks.

Whilst it is not mandatory for most taxpayers to use the framework, the ATO is strongly encouraging taxpayers to use the tool as part of their wider tax governance processes and will ask companies required to complete Reportable Tax Positions to provide information regarding their risk assessment conclusions.

The PCG makes it clear that the risk rating exercise is a separate exercise to whether there has been a transfer pricing benefit obtained. The PCG does not provide technical advice or interpretation and does not constitute a safe harbour.

The framework is a complex one, and uses a similar approach to that in the recent PCG 2017/1, which deals with a risk assessment framework for "marketing hubs". It involves a series of risk 'zones', ranging from white through to red and applies to both outbound and inbound loans. The framework uses a number of factors and allocates a score against the answer for each factor (for each loan). The cumulative score will determine the risk zone that applies to each loan.

The ATO state that where taxpayers have arrangements in higher risk zones, the greater the expectation will be that they have high quality transfer pricing documentation in place to support the arm's-length nature of the arrangements.

This PCG will have effect from 1 July 2017 and will apply to existing and newly created financing arrangements, structures and functions.

In detail

The PCG is in two parts: a statement of general principles and a Schedule which addresses the transfer pricing risk factors associated with related party debt funding. Other risk factors associated with financing arrangements such as the operation of the debt / equity rules, thin capitalisation rules, interest withholding tax provisions or Part IVA are not addressed by the PCG, but may be subject to separate risk analyses which could for example be included in additional schedules to be added to the PCG in the future.

The risk assessment methodology in PCG 2017/D4 is based on a cumulative scoring system, based on both qualitative and quantitative factors. Importantly, the framework is applied against each related party financing arrangement of the Australian taxpayer.

The factors that should be assessed for inbound loans are:

- The interest rate of the loan relative to the cost of "referrable debt", effectively comparing the interest rate with the cost of global debt, traceable third party debt or relevant third party debt of the taxpayer (e.g. how many basis points the interest rate exceeds the cost of referrable debt debt)
- The leverage ratio of the taxpayer: whether consistent with the global leverage, and if not, whether less than or more than 60%
- Interest coverage ratio relative to global ratios
- Appropriate collateral i.e., security, guarantee or covenants (yes/no)
- Subordinated or mezzanine debt (yes/no)
- Currency of debt (i.e., different to the operating currency) (yes/no)
- Whether the arrangement is covered by a taxpayer alert (yes/no)
- The headline tax rate of the lender entity jurisdiction

- Presence of exotic features in the loan e.g. payment in kind, convertibility (yes/no)
- Whether one or more entities is a hybrid entity (yes/no)

For outbound arrangements, the factors that should be assessed are:

- The interest rate of the loan relative to the cost of referrable debt
- Currency of debt (i.e., different to the operating currency) (yes/no)
- Whether the arrangement is covered by a taxpayer alert (yes/no)
- Whether one or more entities is a hybrid entity (yes/no)
- Sovereign risk of borrower entity (from AAA to CCC)

Each response to the above factors, for each loan, is then allocated a point score of (0, 1, 3, 10 or 15) and then a total point score is derived for each loan.

Importantly, the draft PCG states that the abovementioned indicators and their relative weighting have been developed based on the ATO's expectation that, in most cases, the cost of related party financing should align with the financing costs that could be achieved by the ultimate parent company (on an arm's length basis).

The allocation of the risk zone for each loan is based on the cumulative score as follows:

Zone	**Risk rating**	**Score**
Green	Low	0-4
Blue	Low to Moderate	5-10
Yellow	Moderate	11-18
Amber	High	19-24
Red	Very High	25 or more

The overall risk zone for a taxpayer will be that of the loan with the highest risk rating. In terms of ATO activity in relation to each of the zones, the PCG outlines what taxpayers can expect:

Zone	**ATO compliance response**
White	Arrangements already reviewed by the ATO (e.g. APA, settlement) – no further action
Green	Limited compliance activity. ATO may look to confirm the taxpayer's risk assessment
Blue	ATO will actively monitor the loan arrangements
Yellow	ATO will work with the taxpayer to understand and resolve areas of difference
Amber	An ATO review is likely to commence as a matter of priority
Red	An ATO review or audit is likely to commence as a matter of priority

Impacts

This is a complex risk assessment tool and requires a careful analysis of each of the factors identified by the ATO. This also needs to acknowledge that the asymmetry in approaches between inbound and outbound loans could mean that any uniform existing global policy framework may be

assigned different risk ratings (and documentation requirements) depending on which loan it is applied to.

It is of interest that there is no risk indicator at present based on the size of the financing arrangement, which would likely be a point of feedback to the ATO in the consultation period.

Furthermore, some of the ATO's calibration of risks will surprise many. For example:

- A margin 2 per cent over the cost of referrable debt will of itself attract a risk score of 15 points).
- An interest coverage ratio of less than 3.3x will of itself attract a risk score of 10 points, and to obtain a lower risk score, interest coverage needs to be between 3.3x to 9.9x. In our experience this is well above sustainable interest coverage ratios in many industries and observed bank covenant levels

It is important to note that the ATO acknowledges that simply being in a higher risk zone does not mean that an arrangement is inherently non-arm's length. Furthermore it indicates that the expectations regarding the level and quality of transfer pricing documentation and analysis required to substantiate the rate will increase according to the risk rating, as noted above.

We note that the recent Chevron decisions considered a number of the issues that are considered risk factors including currency, leverage and collateral

Senior ATO leadership has described intra-group financing as the "number one risk" it is focused on with regard to multinational taxation and this risk assessment framework is a key element of the ATO's strategy. The ATO is hopeful that taxpayers will use this framework to consider their risk profile and to engage with the ATO prospectively with a view to managing this risk profile.

Voluntary disclosures

The Commissioner recognises that taxpayers may wish to modify their related party financing arrangements to come within the low risk green zone. For a period of 18 months after the PCG is finalised, the ATO is willing to remit penalties and interest for prior years where taxpayers adjust the pricing or level of debt to come within the low risk green zone.

Recommended actions

The release of this PCG signals a significant uplift of ATO focus and activity in the area of cross-border financing. We recommend that taxpayers review their arrangements against the ATO risk assessment framework, noting there is a consultation period on the PCG until 30 June 2017.

Based on that assessment, it may be appropriate to review the financing terms, transfer pricing or legal agreement documentation, and in some cases potentially approach the ATO to obtain certainty.

The impact of the recent Chevron decision, the wider reforms to Australia's transfer pricing rules, and the recent introduction of the Diverted Profits Tax means that taxpayers need to be able to demonstrate the commercial basis for their intercompany financing arrangements, and take a wide global perspective in approaching these issues.

Comments are due by 30 June 2017.

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