



Australia issues draft risk-assessment framework for related-party financing

Global Transfer Pricing Alert 2017-018

The Australian Taxation Office on 16 May 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 seems that the release of the framework was timed to follow the decision in favor 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 a significant impact 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 necessary, companies are welcome, and in fact encouraged, to discuss the issue with the ATO to mitigate any actual or perceived risks. While 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 the Reportable Tax Positions form to provide information regarding their risk assessment conclusions.

The PCG makes it clear that the risk-rating exercise is a separate exercise than determining whether a transfer pricing

benefit has been obtained. The PCG does not provide technical advice or interpretation and does not constitute a safe harbor.

The framework is complex, and uses an approach similar 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" that range from white to red, and it applies to both outbound and inbound loans. The framework uses a number of factors and allocates a score to 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 when taxpayers have arrangements in higher risk zones, the expectation will be higher that they have high-quality transfer pricing documentation in place to support the arm's length nature of the arrangements.

The PCG will be effective 1 July 2017, and will apply to existing and newly created financing arrangements, structures, and functions.

In detail

The PCG has two parts: a statement of general principles and a schedule that addresses the transfer pricing risk factors associated with related-party debt funding. The PCG does not address other risk factors associated with financing arrangements, such as the operation of the debt/equity rules, thin capitalization rules, interest withholding tax provisions, or Part IVA, but those factors may be subject to separate risk analyses that could 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 to 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., by how many basis points the interest rate exceeds the cost of referrable debt)
- The taxpayer's leverage ratio: whether it is consistent with the global consolidated leverage, and if not, whether it's less than or more than 60 percent
- Interest coverage ratio relative to global ratio
- The presence of appropriate collateral (security, guarantee, or covenants)
- The presence of subordinated or mezzanine debt
- Is the currency of debt different from the operating currency?
- Is the arrangement covered by a taxpayer alert?

- The headline tax rate of the lender entity's jurisdiction
- The presence of exotic features in the loan, such as payment in kind, or convertibility
- Whether one or more entities is a hybrid entity

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

- The loan's interest rate relative to the cost of refinerrable debt
- The currency of debt (that is, is it different from the operating currency?)
- Whether the arrangement is covered by a taxpayer alert
- Whether one or more entities is a hybrid entity
- The sovereign risk of the borrower entity (from AAA to CCC)

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

Importantly, the draft PCG states that the above-mentioned indicators and their relative weight 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 to a 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 (for example, APAs or settlements) – 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

Impact

The PCG is a complex risk assessment tool and requires a careful analysis of each of the factors identified by the ATO. Moreover, 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.

Interestingly, the draft PCG does not include the size of the financing arrangement as a risk indicator, which will likely be a point of feedback to the ATO during the consultation period.

Some of the ATO's calibrations of risks will surprise many. For example:

- A margin 2 percent over the cost of refinerrable debt will by itself attract a risk score of 15 points.
- An interest coverage ratio of less than 3.3x will by itself attract a risk score of 10 points; to obtain a lower risk score, interest coverage must 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.

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 leaders have described intragroup 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 hopes that taxpayers will use this framework to consider their risk profile and to engage with the ATO prospectively, with a view to managing their risk profile.

Voluntary disclosures

The Commissioner of Taxation recognizes 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 finalized, the ATO is willing to consider remission of penalties and interest for prior years when 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. 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 broader reforms to Australia's transfer pricing rules, and the recent introduction of the diverted profits tax means that taxpayers must be able to demonstrate the commercial basis for their intercompany financing arrangements, and adopt a wide global perspective in approaching these issues.

There is a consultation period on this draft PCG, and comments are due by 30 June 2017.

[Back to top](#)

Contacts

Geoff Gill (Sydney)

gegill@deloitte.com.au

[Back to top](#)

Useful links

Resources

- [2016 Global Transfer Pricing Country Guide](#)
- [Arm's length standard](#)
- [Transfer pricing alerts](#)

Get Connected

- [Deloitte tax@hand](#)
- [Join Dbriefs](#)
- [Follow @Deloitte Tax](#)
- www.deloitte.com/tax

[Back to top](#)



Get in touch



Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (“DTTL”), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as “Deloitte Global”) does not provide services to clients. Please see www.deloitte.com/about to learn more about our global network of member firms.

Deloitte provides audit, consulting, financial advisory, risk advisory, tax and related services to public and private clients spanning multiple industries. Deloitte serves four out of five Fortune Global 500® companies through a globally connected network of member firms in more than 150 countries and territories bringing world-class capabilities, insights, and high-quality service to address clients’ most complex business challenges. To learn more about how Deloitte’s approximately 245,000 professionals make an impact that matters, please connect with us on [Facebook](#), [LinkedIn](#), or [Twitter](#).

© 2017. For information, contact Deloitte Touche Tohmatsu Limited.

30 Rockefeller Plaza
New York, NY 10112-0015
United States



Official Professional Services Sponsor

Professional Services means audit, tax, consulting, and advisory.

Copyright © 2016 Deloitte Development LLC. All rights reserved.
36 USC 220506

To no longer receive emails about this topic please send a return email to the sender with the word “Unsubscribe” in the subject line.