



## **ATO issues guidance on nonresident-owned mobile offshore drilling units in Australian waters**

### **Global Transfer Pricing Alert 2019-031**

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, the guideline relates to “transfer pricing issues involving the use in Australian waters of nonresident owned mobile offshore drilling units (MODUs).” The draft guideline is proposed to apply both before and after the date of issue.

The draft PCG follows Taxpayer Alert TA 2016/4 (published in April 2016), in which 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 guideline deals with the use in Australian waters of nonresident-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’s request).

#### **To whom does the guideline apply?**

The draft 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 nonresident 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.

Under 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 that are not engaged in any drilling activities and are permanently anchored to the ocean floor;
- Cable-laying vessels that 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.

The guideline also does not apply if the substance of the arrangements differs from their legal form.

### **PCG risk zones**

The ATO has constructed four risk zones, summarized 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. Similarly, 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 to be within the white zone if they have an advance pricing agreement (APA) in respect of their arrangement, an agreed ATO settlement, or if 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 to be low risk if the earnings before interest and tax (EBIT) margin is greater than 10.5 percent in the relevant income year. 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 to be moderate risk if the EBIT margin is less than 10.5 percent but greater than 5 percent in the relevant income year, or if the EBIT margin is 5 percent or less but the total revenue from all Australian contracts or projects is less than AUD 20 million.

### **Red zone – high risk**

Entities will be deemed to be high risk if the EBIT margin is 5 percent or less in the relevant income year (and the total Australian contract revenue exceeds AUD 20 million).

### **ATO activity resulting from risk zone classification**

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 summarized below:

<b>Risk Zone</b>	<b>ATO treatment</b>
<b>White</b>	The risk assessment framework does not need to be applied but ATO activity will depend on the taxpayer's particular circumstances; for example, if the taxpayer has an APA, an annual compliance review process will apply.
<b>Green</b>	The ATO generally will 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).
<b>Amber or red</b>	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 prioritize 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 into 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:

- A 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 aspects to this draft; for example, the fact that the ATO has applied a "de minimis" level (the AUD 20 million 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 apply only 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 harbor 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 2019, with the guidance likely to be finalized shortly thereafter.

## **Contacts**

**Jacques Van Rhyn (Brisbane)**

[jvanrhyn@deloitte.com.au](mailto:jvanrhyn@deloitte.com.au)

**Ockie Olivier (Perth)**  
[oolivier@deloitte.com.au](mailto:oolivier@deloitte.com.au)

**Soulla McFall (Melbourne)**  
[smcfall@deloitte.com.au](mailto:smcfall@deloitte.com.au)

**Geoff Gill (Sydney)**  
[gegill@deloitte.com.au](mailto:gegill@deloitte.com.au)

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