




# ***PCG 2017/4 - ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions***

 This cover sheet is provided for information only. It does not form part of *PCG 2017/4 - ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions*

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## ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions

### **! Relying on this Guideline**

*This Practical Compliance Guideline sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow this Guideline in good faith, the Commissioner will administer the law in accordance with this approach.*

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### **What this Guideline is about**

1. This Practical Compliance Guideline (Guideline) outlines our compliance approach to the taxation outcomes associated with:

- (a) a 'financing arrangement', as defined in section 995-1 of the *Income Tax Assessment Act 1997* (ITAA 1997), or
- (b) a related transaction or contract

entered into with a cross border related party. Such an arrangement, transaction or contract is referred to in this Guideline as a 'related party financing arrangement'. This Guideline does not cover financing arrangements characterised as equity in accordance with Division 974 of the ITAA 1997.

2. We use the framework in this Guideline and the accompanying schedules to assess risk and tailor our engagement with you according to the features of your related party financing arrangement, the profile of the parties to the related party financing arrangement and the choices and behaviours of your group. The tax risk associated with your related party financing arrangement is assessed having regard to a combination of quantitative and qualitative indicators.

3. If your related party financing arrangement is rated as low risk, then you can expect the Commissioner will generally not apply compliance resources to review the taxation outcomes other than to fact check the appropriate risk rating. If your related party financing arrangement falls outside the low risk category, you can expect the Commissioner will monitor, test and/or verify the taxation outcomes. The higher the risk rating, the more likely your arrangements will be reviewed as a matter of priority.

4. You can use the framework set out in this Guideline to:

- (a) assess the tax risk of your related party financing arrangement
- (b) understand the compliance approach we are likely to adopt given the risk profile of your related party financing arrangement
- (c) work with us to mitigate the transfer pricing risk in relation to your related party financing arrangement and be confident you have reduced your risk exposure, and
- (d) understand the type of analysis and evidence we would require when assessing the risk outcomes of your related party financing arrangements.

### **Structure of this Guideline**

5. This Guideline is structured as follows:

- (a) the main body sets out general principles relevant to our framework for considering risk and applying compliance resources to related party financing arrangements, and
- (b) schedules expand on these principles giving more specific details and indicators relevant to considering the risk of compliance activity in relation to your related party financing arrangement.

6. You will need to read and apply the schedules in conjunction with the general principles set out in the Guideline.

7. This Guideline does not provide advice or guidance on the technical interpretation or application of Australia's transfer pricing rules or other taxation provisions.

8. Additional schedules may be included as part of this Guideline providing specific risk indicators for particular types of entities or other financing arrangements. For example, financial guarantees, interest free loans.

9. Where more than one schedule applies to you or your financing arrangement, you should use the schedule which most specifically addresses your circumstances.

### **Date of effect**

10. This Guideline will have effect from 1 July 2017 and will apply to existing and newly created financing arrangements.

11. Each schedule may have effect from a different date. Where this is the case the date of effect will be stated in the relevant schedule.

12. The use and application of this Guideline will be under continuous review over the three years following initial publication. Any revisions to improve its efficacy will be made at the end of the review period or on an 'as necessary' basis. We will consult with you in relation to proposed material changes.

### **Arrangements to which this Guideline applies**

13. This Guideline applies to any financing arrangement entered into with a related party that is not a resident of Australia and which the cross border test under Subdivision 815-B of the ITAA 1997 applies. The Guideline applies to both inbound and outbound related party financing arrangements.

14. Unless explicitly stated in a schedule, the Guideline does not apply to a financing arrangement that is either:

- (a) entered into by a member of a wholly-owned group containing an ADI (as defined in section 995-1 of the ITAA 1997)
- (b) entered into by a member of a wholly-owned group containing an Australian resident securitisation vehicle (as defined in section 995-1 of the ITAA 1997) or an entity to which section 820-39 of the ITAA 1997 applies to
- (c) entered into by a member of a wholly-owned group that is (or contains) an Australian resident taxpayer that has appropriately applied the simplified transfer pricing record-keeping options in relation to loans (inbound and outbound), and
- (d) a form of Islamic finance.

### **The ATO's compliance approach**

15. We concentrate our efforts on international related party dealings that pose the highest risk of not complying with the transfer pricing rules or other relevant provisions identified in a particular schedule.

16. As a consequence of new legislation and court decisions, the approach used by some taxpayers may no longer be appropriate. Therefore, this Guideline highlights arrangements where we see risk of non-compliance and offers opportunities for taxpayers to transition their arrangements to lower risk positions.

17. This Guideline does not constitute a 'safe harbour' and the information provided in this Guideline does not replace, alter or affect, in any way, our interpretation of the relevant law. It does not relieve you of your legal obligation to self-assess your compliance with all relevant taxation laws.

18. Following this Guideline does not limit or waive the operation of the law. However, if you follow this Guideline and align your related party financing arrangement (or your related party financing arrangement already aligns) with the low risk category, we will generally not allocate compliance resources to examine the relevant tax outcomes.

19. We review both inbound and outbound financing arrangements. Australia's transfer pricing rules do not differentiate between inbound and outbound dealings. As such, our interpretation and application of the provisions does not differentiate between scenarios involving inbound or outbound arrangements and transactions.

## Documenting your legal arrangements

20. If we undertake a review of your financing arrangements, our starting point will be the legal agreement(s). Therefore, for arrangements falling within the higher risk zone it is recommended that agreements are put in place reflecting the relative rights, responsibilities and undertakings of each party that accurately reflect the substance of the financing arrangement. The agreements do not need to be as extensive as arrangements involving independent parties, but should include the key terms and conditions that borrowers and lenders would require to enter into the arrangements.

## THE RISK ASSESSMENT FRAMEWORK

21. Our compliance approach will vary depending on the risk rating of your related party financing arrangement. The following principles will assist you to understand how we assess risk in relation to related party financing arrangements and generally allow you to assess your compliance risk.

22. If you fall outside the low risk zone, there is no presumption your related party financing arrangement is uncommercial or otherwise fails to comply with the Australian tax law. Falling outside the low risk zone means we consider your related party financing arrangement, or your treatment of that arrangement, is at risk of giving rise to an inappropriate tax outcome. Therefore, we will generally conduct some form of compliance activity to further test the taxation outcomes of your arrangement.

23. If we conduct a review of your related party financing arrangement, we may take account of other factors beyond those contained in this Guideline. This is because we will need to evaluate, among other things, the evidence that supports the commerciality of your related party financing arrangement.

24. The ATO's related party financing arrangement risk framework is made up of six risk zones.

Risk zone	Risk level
White	arrangements already reviewed and concluded
Green	low risk
Blue	low to moderate risk
Yellow	moderate risk
Amber	high risk
Red zone	very high risk

## What, when and how to risk assess your related party financing arrangements

25. You will need to risk assess each financing arrangement you enter into with a related party that is not a resident of Australia:

- (a) for existing arrangements, either
  - (i) at the start of each income year with subsequent reviews during the year where additional information becomes available (for example, if global group accounts are finalised two months after the start of the income year, the arrangement should be reviewed at that stage), and
  - (ii) before tax returns for the relevant income year are lodged and more contemporaneous financial information is available to assess outcomes for that income year

- (b) where a new arrangement is entered into during an income year, at the time it is entered into.

26. To determine the risk rating for your related party financing arrangement, you need to compare the conditions that actually exist in relation to your related party financing arrangement (or that have been reasonably assumed by you for the purposes of pricing your related party financing arrangement) with the indicators in the relevant schedule. Each indicator carries a particular score and the aggregate score for all relevant indicators will be your 'risk zone' number.

27. Each indicator is expressed either as:

- (a) a closed (yes/no) question, or
- (b) a qualitative or quantitative range.

28. The indicators and their relative weightings reflect features the ATO has observed:

- (a) from market data, relating to transactions between independent parties, obtained from a variety of sources widely used by companies
- (b) independent parties acting at arm's length consider relevant in pricing financing arrangements, and
- (c) through its interaction with taxpayers, to be indicative of tax risk.

29. You should not adjust your arrangements so you sit higher within a particular range (as set out in the relevant schedule) merely because it does not change your risk zone. We will monitor outcomes for related party financing arrangements to ensure there is no such 'drift' within a range for an indicator. For example, if your gearing level (ratio of debt to book capitalisation) is historically 40%, we will monitor instances where your level of debt drifts to 50% but you remain within the same risk zone.

30. Your risk zone for an income year will reflect that of your highest risk financing arrangement. For example, if you have entered into three related party financing arrangements, two of which you assess as being in the yellow zone and one you assess as being in the amber zone, your overall risk zone will be amber.

31. Generally, the risk scoring is to be based on the most relevant finalised financial accounts available. However, if you feel a multi-year average, a point in time approach or an alternative approach is more appropriate for your circumstances, you may request an exception to the general rule by emailing your rationale to [International@ato.gov.au](mailto:International@ato.gov.au).

32. You will be taken to be in the same risk zone for the entire year unless you subsequently enter into additional related party financing arrangements, which places you in a higher risk zone.

33. You are deemed to be in the white zone and do not need to self-assess the risk rating of your related party financing arrangement where:

- (a) any of the following apply to a related party financing arrangement for the current year
  - (i) an advance pricing arrangement (APA)
  - (ii) a settlement agreement between you and us
  - (iii) a court decision, and
  - (iv) we have conducted a review of your related party financing arrangement (where the review commenced on or after 1 January 2015) and provided you with a low risk rating for your financing arrangement.

AND

- (b) there has not been a material change in the conditions of the related party financing arrangement including the terms, pricing, global group funding arrangements, comparability factors and/or risks since the time of the agreement, decision or review.

34. In performing your self-assessment you may consider certain features of your business or circumstances result in a risk zone that is not reflective of your underlying risk. Where this occurs you may engage with us with your rationale and, if we find it acceptable, a white zone risk assessment may be granted.

35. For example, a capital intensive project in start-up phase may report a low interest coverage ratio which results in a higher risk zone. If this interest coverage ratio is the only indicator causing you to fall outside the green zone, you may engage with us to request a white zone risk assessment.

36. You must confirm eligibility with us before self-assessing yourself within the white zone.

### Evidencing your self-assessment

37. We may, in the course of our ordinary compliance activities or any specific assurance activity relating to this Guideline, fact check your assessment of your risk zone. If you are unable to provide adequate evidence to support your assessment, we may undertake further compliance activity.

38. Where you have concluded the actual conditions of your related party debt do not reflect arm's length conditions, you should prepare and retain comprehensive analysis and data in order to support your choice of substituted conditions which do satisfy arm's length conditions.

### Reporting your self-assessment

39. You may be required to disclose whether you have self-assessed the risk rating of your related party financing arrangement. If you are notified by us to complete a Reportable Tax Position (RTP) schedule, you will be asked to disclose your self-assessed risk zone. It is not a requirement for you to self-assess your risk rating, but if you are unable to (or choose not to) you will also need to disclose this on the RTP schedule. Only arrangements entered into since 1 January 2015 should be reported for RTP schedule reporting purposes.

40. Where you qualify in accordance with paragraph 33 of this Guideline that you are in the white zone, your reporting disclosure is that you are in the white zone.

### What you can expect given your risk zone

41. You can expect the following treatment depending on your risk zone.

Risk zone	ATO treatment
White	No review other than to confirm ongoing consistency with the agreed/determined approach
Green	If there have been no material changes (as outlined in paragraph 33(b) of this Guideline), then we will: (a) generally only apply compliance resources to the arrangement to: i. confirm your calculations were done according to our guidance ii. verify your eligibility, including factually confirming your scores for relevant

	<p>indicators</p> <p>(b) extend the benefits of Practical Compliance Guideline PCG 2017/2 <i>Simplified transfer pricing record-keeping options</i> to your financing arrangement</p> <p>(c) where requested, agree on an APA</p> <p>(d) not seek to apply the diverted profits tax to your financing arrangements</p> <p>We will apply compliance resources to review your related party financing arrangement in exceptional circumstances, such as where:</p> <p>(a) we are not satisfied your risk zone assessment is adequately supported with evidence</p> <p>(b) we become concerned, from our own data and analysis, your scores for certain indicators are inaccurate</p> <p>(c) we become concerned, from our own data and analysis, there is 'drift' within a range for an indicator</p> <p>(d) your related party financing arrangement relates to a broader set of circumstances being reviewed by us in relation to provisions not addressed in the relevant schedule to this Guideline</p> <p>(e) any other circumstances identified in the relevant schedule</p>
Blue	<p>We will actively monitor your arrangements using available data and will review arrangements by exception</p> <p>Alternative dispute resolution (ADR) might be effective in resolving any areas of difference</p>
Yellow	<p>We will work with you to understand and resolve areas of difference</p> <p>ADR might be effective in resolving any areas of difference</p>
Amber	<p>Reviews are likely to be commenced as a matter of priority</p> <p>We will work with you to understand and resolve areas of difference</p> <p>ADR might be effective in resolving any areas of difference</p>
Red	<p>Reviews are likely to be commenced as a matter of priority</p> <p>Cases might proceed directly to audit</p> <p>You will not be eligible to access the APA program</p> <p>We are likely to use formal powers for information gathering</p> <p>Practically, it will be more difficult to resolve disputes through settlement or ADR</p> <p>You might face an increased prospect of litigation</p>

### Who to contact

42. We have a dedicated team responsible for the oversight and management of related party financing arrangement risks. If you wish to discuss your related party financing arrangement with the ATO you may contact the International Tax Structuring team at [International@ato.gov.au](mailto:International@ato.gov.au).

43. Alternatively, if you have a dedicated relationship manager, you may approach them directly for assistance with your case.

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**Commissioner of Taxation**

18 December 2017

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## SCHEDULE 1: Related party debt funding

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### Scope of this Schedule

44. Generally, we expect pricing of a related party debt to align with the commercial incentive of achieving the lowest possible 'all in' cost to the borrower. We also expect in most cases, the cost of financing to align with the costs that could be achieved, on an arm's length basis, by the parent of the global group to which the borrower and lender both belong. The indicators in this Schedule and their weighting have been developed with this expectation in mind.

45. This Schedule is limited to risks relating to the application of the transfer pricing rules in Division 815 of the ITAA 1997 or an international tax agreement, as defined in section 995-1 of the ITAA 1997. It does not set out our approach reviewing other taxation issues that might arise in relation to related party debt such as the:

- application of the debt/equity rules in Division 974 of the ITAA 1997
- substantive deductibility of interest payments or other losses (for example, under subsection 230-15(2) of the ITAA 1997)

- application of the thin capitalisation rules in Division 820 of the ITAA 1997
- existence or otherwise of liability for interest withholding tax, and
- application of Pt IVA of the *Income Tax Assessment Act 1936* (ITAA 1936).

### Interaction with future schedules

46. The risk indicators contained in paragraphs 55 and 56 of this Schedule may be modified by future schedules to this Guideline. The exact nature and extent of any modification or further interaction between this Schedule and others will be contained in the subsequent schedules.

### Review of Schedule

47. We may review and modify the indicators contained in this Schedule to align it with changes in the Australian debt market conditions. Our review will be contingent on the movement of certain indicators contained in the 'Aggregate Measures of Australian Corporate Bond Spreads and Yields' statistical table maintained by the Reserve Bank of Australia.

48. For example, the basis points applied in the Price indicator reflects the current Australian debt capital market conditions. If these market conditions significantly change, the score and the basis points applied to this indicator will be reviewed and may be modified to reflect those changes.

49. Any changes to the scoring will align with the change in the underlying indicator. The changes will be prospective and will not be applicable to any tax return completed prior to the change being published.

### Related party financing risk indicator guide

50. Determining your risk zone requires you to:

- select the appropriate criteria for your financing arrangement (an outbound loan; that is, you're an Australian taxpayer lending to a related party or an inbound loan; that is, you're an Australian taxpayer borrowing from a related party)
- identify the indicators (left hand column of the tables) relevant to your circumstances, and
- determine your score (first row of the tables) for each indicator based on the actual conditions applying to your related party debt (or you have taken to exist for the purposes of pricing the related party debt according to arm's length conditions).

51. Where the indicator is expressed as a range, your score for that indicator will be determined by reference to where you sit in that range.

52. An indicator with a score of 10 or 15 is individually capable of resulting in a risk score outside the green zone.

53. Your risk zone is determined by combining your outcomes under the pricing and motivational risk scoring tables (paragraphs 55 and 56 of this Schedule, respectively) according to the following matrix:

		MOTIVATIONAL		
		A	B	C
PRICING	1			
	2			
	3			
	4			
	5			

54. An explanation of each indicator (including how to calculate, where relevant) is given at paragraphs 58 to 96 of this Schedule.

55. Pricing risk scoring table:

Indicator	Outbound			Outbound & Inbound	Inbound			
Score	10	3	1	0	1	3	10	15
Price relative to: - traceable third party debt - relevant third party debt of the group - global group cost of funds	Zero charged	Less than the cost of referable debt		Inbound: ≤50 bps over cost of referable debt (or less than referable debt) Outbound: Cost of referable debt or higher	>50 but ≤100 bps over cost of referable debt	>100 but ≤150 bps over cost of referable debt	>150 but ≤200 bps over cost of referable debt	>200 bps over cost of referable debt
Appropriate collateral				Yes		No		
Subordinated debt (including mezzanine debt)				No		Yes		
Currency of debt is not consistent with operating currency	Yes			Inbound – No Outbound – No, except when the currency is consistent with lender's accounting and tax functional currencies			Yes	
Presence of exotic features or instruments				No			Yes	
Sovereign risk of borrower entity	B, CCC	BB	A, BBB	AAA, AA				
<b>Zone</b>								
<b>1</b>	0							
<b>2</b>	1-3							
<b>3</b>	4-9							
<b>4</b>	10-14							
<b>5</b>	15 or more							

56. Motivational risk scoring table:

Indicator	Outbound			Outbound & Inbound	Inbound				
Score	10	3	1	0	-1	1	3	10	15
Leverage of borrower				Consistent with or lower than the global consolidated leverage	Greater than global consolidated leverage but ≤50% of historic cost base of assets	Greater than global consolidated leverage but ≤60% leverage		>60% leverage*	
Interest coverage ratio				Consistent with or greater than the global consolidated group		Lower than global consolidated group ratio but ≥4.2	≥1.4 but <4.2	<1.4	
Applicable tax rate of lender entity jurisdiction				≥30%, or lender entity is global parent or global treasury operation		21-29%	16-20%	1-15%	0%
Involves an arrangement covered by a taxpayer alert	Yes			No				Yes	
Involves a hybrid arrangement	Yes			No					Yes
<b>Zone</b>									
<b>A</b>	≤4								
<b>B</b>	5-13								
<b>C</b>	14 or more								

## Evidencing your self-assessment of your risk zone

57. The following are examples of evidence, which would be prudent to have in place in order to minimise the burden of any such fact checking, as described in paragraph 37 of this Guideline.

Indicator	Example of evidence
<ul style="list-style-type: none"> <li>Pricing of your related party debt</li> <li>Size of your related party debt</li> <li>Tenor</li> <li>Subordination</li> <li>Exotic features</li> <li>Currency</li> <li>Existence of guarantees or security</li> </ul>	Relevant executed legal agreements setting out these terms
<ul style="list-style-type: none"> <li>Traceable third-party debt</li> </ul>	<p>Relevant executed legal agreement setting out the terms of that external loan</p> <p>Contemporaneous records, such as Board minutes, indicating the funds drawn down under the external loan were on lent via the related party debt</p>
<ul style="list-style-type: none"> <li>Operating currency of the Australian group</li> </ul>	<p>Bank statements</p> <p>Industry data (supported by financial statements)</p> <p>Major sales contracts indicating the currency used</p>
<ul style="list-style-type: none"> <li>Hybrid arrangement</li> </ul>	<p>Evidence of registration under the relevant legislation in the jurisdiction of incorporation</p> <p>Constitutions (or equivalent legal agreements) of the parties to the related party debt</p>
<ul style="list-style-type: none"> <li>Leverage of the Australian group or global group</li> <li>Interest coverage ratio</li> <li>Global group's cost of funds</li> </ul>	Audited financial accounts of the Australian group or the audited consolidated financial accounts of the group's parent entity (or the equivalent to such accounts where such accounts, or a single set of such accounts, are not prepared)
<ul style="list-style-type: none"> <li>Residency of the lender</li> </ul>	<p>Evidence of the jurisdiction of incorporation or registration</p> <p>Other evidence of central management and control</p>
<ul style="list-style-type: none"> <li>Arrangements where arm's length conditions are substituted for actual conditions for the purposes of deriving an interest rate (for example, a legally subordinated loan is priced as a senior loan)</li> </ul>	Documentation as to the arm's length conditions applied and how the pricing was determined (usually contained within transfer pricing documentation)

## Definitions

### ***Global group***

58. The definition of global group differs based on the structure of the group.

Structure	Definition
Publicly listed companies	As per the definition of a member of a group of entities consolidated for accounting purposes in accordance with paragraph 960-555(2)(a) of the ITAA 1997 <sup>1</sup>
Privately owned companies	Includes the taxpayer and their associates as defined in section 318 of the ITAA 1936
Joint venture/consortium entities	Where a joint venture partner or consortium member with more than 20% direct or indirect interest in the entity has provided capital by way of debt, that particular instrument is assessed against the global group of that particular joint venture partner or consortium member

### ***Consistent with the global consolidated group***

59. 'Consistent with global consolidated group' means a ratio that has been calculated in accordance with their respective definition, which is either equal to or within a 10% differential. For example, if your leverage is within a factor of 0.9 to 1.1, they will be taken as consistent.

### ***Priced relative to traceable third-party debt, relevant third-party debt of the group, or global group cost of funds***

60. This indicator requires a comparison of the 'all in' cost of debt under the related party financing arrangement to the cost of debt issued to an unrelated third party. 'All in' cost is all the cost associated or connected to the pricing of the debt. For example, guarantee fees, associated hedging cost, line fees and any anticipated foreign exchange gains or losses.

61. Three options for comparison are available, which must be considered in the following order:

1. Traceable third-party debt.
2. Relevant third-party debt.
3. Global group cost of funds.

62. The comparison can only be in respect of one of the options. For example, where traceable third-party debt is available for use it must be used and the other two options cannot be used.

63. Related party debt is considered traceable third-party debt when:

- (a) the key terms, conditions and events (including but not limited to, start date of the arrangement, principal drawdown, repayments and the interest rates)

<sup>1</sup> Although section 960-555 of the ITAA 1997 refers to significant global entities, this is not limited to only significant global entities.

of the related party debt provided to or by the taxpayer mirror those of the third-party debt obtained by the group, and

- (b) the group's accounting systems can demonstrate the appropriate amount of cash being provided by the third party to a group member(s) and that this entity then provided the same amount of cash to the borrowing entity.

64. Relevance for third-party debt of the borrowing entity exists where the nature of the third party and the related party borrowing are consistent. For example, medium or long term bonds issued by the borrowing entity would be relevant third-party debt for long-term debt provided by a related party. By way of contrast, working capital or overdraft facilities with banks would not be considered relevant. Any third-party debt of the borrowing entity should be considered first and then that of other members of the global group.

65. Global group cost of funds is defined as:

$$\frac{\text{Group interest}}{\text{Average of opening and closing debt balances}}$$

where:

- **Group Interest** = gross interest expense **plus** other borrowing expenses (for example, fees, swap costs) per the income statement of the consolidated global group accounts, in Australian dollar (A\$) equivalent
- **Debt** = short-term debt **plus** current portion of long-term debt **plus** long-term debt (net of current portion) **plus** liability for capital leases (if not already included in debt) per the balance sheet or asset statement of audited financial reports, in A\$ equivalent.  
Note debt does not include other types of liabilities
- **Closing balance** = balance as at the end of the accounting period that most closely matches the income tax year of the taxpayer
- **Opening balance** = balance as at the end of the previous accounting period, relative to the closing period

OR

For a newly issued debt instrument, the global cost of funds is what the group's cost of debt would be for that particular instrument at the time it is entered into, where the taxpayer can provide evidence of this.

66. If the currency of the relevant reference rate is different to the currency of the related party borrowing the reference rate will require adjusting. For example, if traceable third-party debt is borrowed in Euros and the related party borrowing is in Australian dollars (A\$), the traceable third-party debt would need to be converted to an A\$ equivalent rate.

67. You calculate the A\$ equivalent rate by taking the average of either the:

- (a) spread over the relevant currency base rate and applying that spread to a relevant A\$ base rate. For example, if the group records borrowings in US\$ and has an average cost of debt of US\$ Libor + 80 bps, the A\$ equivalent rate can be taken to be A\$ Bank Bill Swap Rate (BBSW) + 80bps, or
- (b) interest rate in the relevant group's currency and converting the rate to A\$ equivalent using a cross-currency interest rate swap conversion tool.

68. If you have no third-party debt arrangements, we recommend you contact us to discuss an appropriate pricing indicator for your specific circumstances.



### ***Appropriate collateral***

69. Appropriate collateral refers to the appropriate levels of protection that would be expected to be provided by the borrower to the lender in independent dealings. From our observations of market activity, this will generally depend on the credit rating of the issuing entity. For example, it is more common for non-investment grade entities to offer security over assets than for investment grade entities.

70. Appropriate collateral may include:

- (a) Provision of security – where the borrower pledges assets as collateral for the debt, which can be repossessed if the borrower stops making loan payments. Our observations are that lenders will generally try to maximise the value of the security available against their debt.
- (b) A guarantee – defined as a legal obligation for a third-party guarantor to assume the liabilities of the borrower to the lender, in the event the borrower is unable to meet its interest or principal repayments.
- (c) Covenants (including representations, warranties and events of default) – promises that certain activities or events will or will not occur or that the borrower will stay above or below determined ratios. Common covenants include
  - (i) a prohibition from issuing debt which ranks higher
  - (ii) a restriction on the amount of debt raised, often expressed by way of a gearing ratio
  - (iii) restrictions on the sale of assets
  - (iv) minimum working capital requirements, and
  - (v) interest cover or debt service cover ratios.

71. Answer yes if the lack of appropriate collateral has not been taken into account in pricing the financial arrangement.

### ***Subordinated debt (including mezzanine debt)***

72. Subordinated debt is defined as a loan or security that ranks below other loans and securities with regard to claims on a company's assets or earnings in the event of a default. Subordination may arise from the terms of the debt itself or through structural subordination.

73. Answer no if subordination has not been taken into account in pricing the financial arrangement.

### ***Currency of debt is not consistent with operating currency***

74. The operating currency of the borrower is either:

- (a) the currency in which it earns the majority of its revenues, or
- (b) any currency where the borrower has free cash flow greater than or equivalent to 150% of the anticipated interest expense in that particular currency.

### ***Presence of exotic features or instruments***

75. Exotic features or instruments include:

- (a) payment in kind or other forms of interest payment deferral

- (b) promissory notes or other instruments that do not provide rights to foreclose/accelerate repayment etcetera
- (c) options which give rise to premiums on interest rates (for example, early repayment by the borrower or loan calls to the lender)
- (d) convertibility to equity or other exchange
- (e) contingencies (for example, interest only repaid under certain conditions),
- (f) the legal or borrowing currency, as reflected in the terms of the loan, is different to the operating currency
- (g) the currency actually transferred or effectively provided by the lender to the borrower is different to your operating currency.

76. Answer no if the exotic features or instruments included in the arrangement have not been factored into the pricing of the financial arrangement.

### ***Sovereign risk of borrower entity***

77. Sovereign rating of the jurisdiction of the borrower is determined as per Moody's, Standard and Poor's (S&P), or Fitch. The equivalent ratings of these agencies are provided in paragraph 78 of this Schedule. If no sovereign rating is provided by any of the agencies then assume a CC rating or equivalent.

78. Equivalent ratings:

#### **Investment grade**

Moody's	Aaa	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3
S&P	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-
Fitch	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-

#### **Non-investment grade**

Moody's	Ba1	Ba2	Ba3	B1	B2	B3	Caa1	Caa2	Caa3	Ca
S&P	BB+	BB	BB-	B+	B	B-	CCC+	CCC	CCC-	CC
Fitch	BB+	BB	BB-	B+	B	B-	CCC+	CCC	CCC-	CC

79. If your pricing arrangements have made reliable adjustments for the sovereign risk of the borrower entity relative to Australian sovereign risk, then assume the sovereign risk is AAA.

80. For example, for a loan made between an Australian entity (AAA rated) and an entity in a jurisdiction where the sovereign risk is BB, the difference in rate between AAA and BB is calculated at equivalent to 125 bps. This difference (125 bps) is then added to the lending rate to compensate for the sovereign risk.

81. If Australia's credit rating falls below AAA and a jurisdiction is rated equal to or higher than Australia then no adjustment for sovereign risk is required.

### ***Leverage of borrower***

82. This indicator requires comparison of the leverage of the Australian taxpayer and the global group or other leverage ranges listed in the motivational risk score table.

83. Leverage of taxpayer is defined as:

$$\frac{\text{tax debt}}{\text{total Australian assets}}$$

where:

- **tax debt** = debt for Division 974 purposes, in A\$ equivalent
- **total Australian assets** = current and non-current assets attributable to Australian operations less amounts lent to, and invested in, associate entities

The value of these assets shall be the amount recorded in audited financial reports or historic cost where those reports are not available.

84. Leverage of group is defined as:

$$\frac{\text{Debt}}{\text{Total assets as contained in the groups consolidated accounts}}$$

where:

- **debt** is as defined in paragraph 65 of this Schedule.

85. Where your leverage is consistent with your global group's consolidated leverage your score for this indicator is zero and the motivational risk scoring table in paragraph 56 of this Schedule is not applied to your 'stand alone' leverage.

86. If you are a financial entity for thin capitalisation purposes, you may substitute the 60% leverage benchmark in this indicator for your pre-asset revaluation safe harbour gearing ratio. For example, an inward investing financial entity that has a pre-asset revaluation safe harbour gearing ratio of 78% may replace the 60% leverage benchmark in this indicator with their safe harbour gearing ratio.

87. Pre-asset revaluation safe harbour gearing ratio defined as:

$$\frac{\text{Pre-asset revaluation safe harbour debt amount}}{\text{Total Australian assets}}$$

where:

- **Pre-asset revaluation safe harbour debt amount** = Safe harbour debt amount for Division 820 purposes before accounting for any asset revaluation that were conducted for thin capitalisation purpose only; in A\$ equivalent

### **Interest coverage ratio**

88. Interest coverage ratio =  $\frac{\text{EBITDA}}{\text{interest}}$

where:

- **EBITDA** = pre-tax income + interest + non-recurring expenses (gains) + depreciation expenses + amortisation of intangibles
- **Interest** = gross interest expense + other borrowing expenses

And

- **Other borrowing expenses** include, for example, fees and swap costs. Amounts are per the income statement. Note that interest income is not included.
- **Gross interest expense** = interest paid or credited. It includes amounts accrued, accumulated or capitalised.

#### **Applicable tax rate of lender entity jurisdiction**

89. The applicable tax rate is the corporate rate of taxation for the jurisdiction to which the lending entity is a tax resident.

90. Where the tax rate applied to the lending entity or the lending entity's interest income (for example, tax holidays or concessional tax treatment of certain income) is different to the headline rate (even temporarily) the actual rate applied should be used for this indicator.

91. If the lending entity is not a tax resident of any jurisdiction, assume the headline tax rate is 0%.

92. No points should be assigned for the purpose of this indicator where the lending entity is either:

- (a) the ultimate parent entity
- (b) a subsidiary of the ultimate parent entity, whose ownership chain remains in the same jurisdiction as the ultimate parent entity, and it and all members of its ownership chain are taxed as corporations in the parent's jurisdiction, or
- (c) the global Treasury entity for the group with the sole purpose to manage the capital requirements of the group including, but not limited to, the raising of third-party finance, management of interest rate or currency exposures with third parties and management of the group's cash positions. There must be substance to its operation evidenced through having sufficiently senior employees and capital to effectively control, manage and bear the risks of managing the group's treasury operations.

93. Where the ultimate parent entity is exempt from paying income tax in the jurisdiction it is a tax resident of (for example, sovereign wealth funds, pension funds), no points should be assigned for the purposes of this indicator.

#### **Involves an arrangement covered by a taxpayer alert**

94. Answer yes if you have an arrangement that can reasonably be described as being covered by any of the following taxpayer alerts:

- Taxpayer Alert TA 2016/1 *Inappropriate recognition of internally generated intangible assets and revaluation of intangible assets for thin capitalisation purposes*
- Taxpayer Alert TA 2016/3 *Arrangements involving related party foreign currency denominated finance with related party cross-currency interest rate swaps*
- Taxpayer Alert TA 2016/9 *Thin capitalisation – Incorrect calculation of the value of 'debt capital' treated wholly or partly as equity for accounting purposes*
- Taxpayer Alert TA 2016/10 *Cross-Border Round Robin Financing Arrangements*

- All taxpayer alerts released after the publication of this Guideline dealing with financial arrangements.

### ***Involves a hybrid arrangement***

95. Answer yes if the income (gain) or expenditure (loss) from your financial arrangements (including derivatives or spot transactions) is not subject to consistent or symmetrical tax treatment under the laws of the relevant overseas tax jurisdiction(s). Inconsistent treatment includes that due to tax deferral, or the treatment of the entity or other ownership arrangement in connection with holding or issuing of the financial arrangement. Tax treatment does not refer to differences in tax rates between jurisdictions.

### **Examples of how to determine your risk zone**

#### ***Example 1 – Australian subsidiary of a US oil and gas company***

96. *ForCo Inc. is a company incorporated in the United States of America (US) and is the parent of the global group. AusCo Pty Ltd is an Australia subsidiary of ForCo Inc.*

97. *Relevant aspects of ForCo Inc. and AusCo's profiles are detailed in the following table:*

	<b>ForCo</b>	<b>AusCo</b>
<i>Year end</i>	<i>31 December (accounting)</i>	<i>31 December (tax and accounting)</i>
<i>Interest coverage ratio</i>	16	13
<i>Leverage</i>	33% <sup>2</sup>	35% <sup>3</sup>
<i>Average cost of debt</i>	2.54%	

98. *AusCo Pty Ltd is in the oil and gas industry, primarily undertaking exploration for, and extraction of, gas. It has an accounting and tax functional currency of U.S. dollars (USD). On 1 January 2016 AusCo Pty Ltd receives a loan from a related party. The relevant terms of the loan, as set out in the executed legal agreement, are:*

- *interest rate of 6.16%*
- *currency is USD*
- *the loan is subordinated to senior debt, and*
- *no security.*

99. *The loan:*

- *is not a hybrid instrument*
- *does not involve hybrid entities*
- *does not have exotic features, and*
- *there are no associated related party derivatives.*

100. *The lender is in Hong Kong, which has a headline tax rate of 16.5%.*

101. *AusCo claims a 3.16% interest rate on its USD loan as the loan is priced as a senior debt for tax purposes.*

<sup>2</sup> Interest coverage ratio, average cost of debt and leverage are calculated according to this Schedule, using data from ForCo Inc.'s financial accounts for the year ended 31 December 2015.

<sup>3</sup> Leverage and interest coverage ratio are calculated according to this Schedule, using data from AusCo Pty Ltd.'s tax filings and financial accounts for the year ended 31 December 2015, respectively.

102. The risk indicator guide is applied to the circumstances of AusCo Pty Ltd as follows:

<b>Pricing indicator</b>	<b>Application of criteria</b>	<b>Score</b>
<i>Priced consistently with global group cost of debt</i>	<i>3.16% is 62 basis points higher than the group average cost of 2.54%</i>	<i>1</i>
<i>Security</i>	<i>None</i>	<i>3</i>
<i>Subordination</i>	<i>None</i>	<i>0</i>
<i>Currency of debt is different to operating currency</i>	<i>No</i>	<i>0</i>
<i>Exotic features</i>	<i>No</i>	<i>0</i>
<b>Total</b>		<b>4</b>

<b>Behavioural indicator</b>	<b>Application of criteria</b>	<b>Score</b>
<i>Leverage</i>	<i>Consistent with parent</i>	<i>0</i>
<i>Interest coverage ratio</i>	<i>13</i>	<i>1</i>
<i>Headline tax rate of lender entity jurisdiction</i>	<i>16.5%</i>	<i>3</i>
<i>Involves an arrangement covered by a taxpayer alert</i>	<i>No</i>	<i>0</i>
<i>Hybrid arrangements</i>	<i>No</i>	<i>0</i>
<b>Total</b>		<b>4</b>

103. AusCo Pty Ltd's score of four for both indicators places it in zone 3 for pricing and zone A for behaviour. It's combined score places it in the yellow zone – moderate risk.

104. AusCo Pty Ltd would likely be in the green zone if it:

- offered security as part of the terms of the loan, and
- priced the related party debt at no more than 50 basis points above the global group cost of debt (with flow on effects on AusCo Pty Ltd.'s interest coverage ratio).

#### **Example 2 – New Zealand subsidiary of an Australian asset management company**

105. AusCo Limited is an Australian incorporated asset management company listed on the ASX and is the parent of the global group. ForCo Ltd is a New Zealand subsidiary of AusCo Limited.

106. Relevant aspects of AusCo Limited and ForCo Ltd.'s profiles are as follows:

	<b>AusCo</b>	<b>ForCo</b>
<i>Year end</i>	<i>30 June (accounting)</i>	<i>30 June (accounting and tax)</i>
<i>Average cost of debt</i>	<i>2.54%<sup>4</sup></i>	
<i>Functional currency</i>	<i>Australian dollars (accounting and tax)</i>	<i>New Zealand dollars (accounting and tax)</i>
<i>Sovereign risk rating</i>	<i>AAA</i>	<i>A</i>

<sup>4</sup> Average cost of debt is calculated according to this Schedule using data from AusCo Limited's audited financial accounts for the year ended 30 June 2015.

107. ForCo Ltd is in the real estate industry, primarily undertaking management and investment in real estate.

108. On 1 January 2016 AusCo Limited provides a loan to ForCo Ltd; the relevant terms of the loan as set out in the executed legal agreement, are an interest rate of 0.00% and currency of Australian dollars.

109. The loan:

- is not a hybrid instrument
- does not involve hybrid entities
- does not involve arrangement covered by a taxpayer alert, and
- has no associated related party derivatives accompanying it.

110. The risk indicator guide is applied to the circumstances of AusCo Pty Ltd as follows:

<b>Pricing indicator</b>	<b>Application of criteria</b>	<b>Score</b>
<i>Priced consistently with global group cost of debt</i>	<i>Zero interest on the related party facility</i>	<i>10</i>
<i>Currency of debt is different to operating currency</i>	<i>Yes, but consistent with AusCo's tax and accounting functional currency</i>	<i>0</i>
<i>Sovereign risk of borrower entity</i>	<i>Sovereign risk of New Zealand is A</i>	<i>1</i>
<b>Total</b>		<b>11</b>

<b>Behavioural indicator</b>	<b>Application of criteria</b>	<b>Score</b>
<i>Involves an arrangement covered by a taxpayer alert</i>	<i>No</i>	<i>0</i>
<i>Hybrid arrangement</i>	<i>No</i>	<i>0</i>
<b>Total</b>		<b>0</b>

111. AusCo Limited's score of 11 for pricing and zero for behavioural places it in zone 4 and zone A, respectively. Their combined score places them in the amber zone – high risk.

112. AusCo Limited could be in the green zone if it:

- charged an appropriate interest rate on its facility with ForCo Ltd, and
- applied an appropriate adjustment for the sovereign risk of the borrower entity.

113. In this example, a review would consider the application of Australia's transfer pricing rules and potentially the application of general deductibility provisions to the extent that AusCo incurred financing costs in order to on-lend to its New Zealand subsidiary.

## SCHEDULE 2: Related party derivative arrangements

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## Scope of this Schedule

114. This Schedule sets out specific risk indicators for related party derivative arrangements that are used to hedge or manage the economic exposure of a company or group of companies. In the normal course of events any derivative transaction being scored **needs to be with a related party and hedging a related party financing arrangement**. Notwithstanding this defined scope there is one exception where the scope of the Schedule is broadened. Where the transaction or contract involves a derivative being a total return swap (TRS) then the TRS should be scored even where the parties are not related. There is no need for the TRS to be related to a financing arrangement or be with a related party to be scored under this Schedule.

115. Where a derivative is used for commercially rational hedging purposes, that is, to manage an economic exposure for a company or group of companies, the derivative will normally be entered into with an unrelated third party (either directly or indirectly via one or more interposed related parties). Where the derivative is entered into with a related party, the ATO is likely to consider the arrangement as higher risk unless the terms and conditions of the related party derivative are then backed out to a non-related party dealing at arm's length in the external market on mirror terms. Where a derivative has been either directly or indirectly, via one or more interposed related parties, backed out to the external market to a non-related party dealing at arm's length on mirror terms then the arrangement being scored will only be in either the green or blue zone<sup>5</sup> (this excludes TRS arrangements).

116. The risk indicators set out in this Schedule have been developed with these matters in mind. You can use the indicators to consider the risk of compliance activity in relation to the following issues which arise in relation to related party derivative arrangements:

- deductibility of payments
- liability to withholding tax
- the application of the transfer pricing rules in Division 815 of the ITAA 1997
- the application of Part IVA of the ITAA 1936 to schemes which are confined to such arrangements.

117. This Schedule does not provide interpretative or related guidance on Division 815, Part IVA or any other taxation provisions.

118. In addition, this Schedule does not set out our compliance approach to reviewing other taxation issues which can arise in relation to related party derivative arrangements, including but not limited to:

- the application of the debt/equity rules in Division 974 of the ITAA 1997
- the application of the thin capitalisation rules in Division 820 of the ITAA 1997
- the application of the hybrid mismatch rules in Division 832 of the ITAA 1997.

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<sup>5</sup> See indicator guide – compliance attribute (v) at paragraphs 127 to 133 of this Schedule.

## Interaction with future schedules

119. The risk indicators set out in this Schedule may be modified by future schedules to this Guideline. Where relevant, the nature and extent of any interaction between this Schedule and a future schedule will be contained in that future schedule.

## Date of effect

120. This Schedule has effect from 1 January 2019 and applies to existing and newly created related party derivative arrangements.

## Transitioning existing arrangements to the green zone

121. The Commissioner recognises the publication of this Schedule may cause taxpayers to review their derivative financial arrangements. Consequently, some taxpayers may modify their arrangements to prospectively come within the green zone.

122. Until 30 June 2020 we will consider remitting shortfall penalties<sup>6</sup> to nil and the shortfall interest charge<sup>7</sup> to the base rate if certain pre-conditions are met. The conditions are that you make a voluntary disclosure in relation to all income years where your arrangements are in place and adjust your historic and prospective derivative financial arrangements to come within the green zone. If you do so, we will view this as a strong factor in favour of exercising the Commissioner's discretion to remit.<sup>8</sup>

123. Taxpayers may inform us if they wish to transition their arrangements during or before a risk review, pre-compliance review, justified trust review or any similar product, but not after any notification to the taxpayer of the commencement of formal audit activity.

124. For the back years within the amendment period, when the derivative financial arrangement was in place, you may be subject to the compliance approach outlined in this Guideline for the risk zone your derivative financial arrangements fall within.

125. Taxpayers wishing to modify their derivative financial arrangements on a prospective basis can notify us through existing ATO relationship teams or via email to [International@ato.gov.au](mailto:International@ato.gov.au) of their intention to transition their arrangements. Taxpayers are required to provide details regarding:

- a. existing derivative financial arrangements including how those arrangements comply with this Schedule
- b. proposed derivative financial arrangements and their compliance with this Schedule
- c. how the transition will be executed and any tax consequences associated with the transition, and

<sup>6</sup> Division 284 of Schedule 1 to the *Taxation Administration Act 1953*.

<sup>7</sup> Division 280 of Schedule 1 to the *Taxation Administration Act 1953*.

<sup>8</sup> The Commissioner's guidelines on remission of shortfall penalties are set out in Law Administration Practice Statement PS LA 2011/30 *Remission of administrative penalties relating to schemes imposed by subsection 284-145(1) of Schedule 1 to the Taxation Administration Act 1953*, Law Administration Practice Statement PS LA 2012/4 *Administration of the false or misleading statement penalty – where there is no shortfall amounts*, Law Administration Practice Statement PS LA 2012/5 *Administration of the false or misleading statement penalty – where there is a shortfall amount*, Law Administration Practice Statement PS LA 2014/2 *Administration of transfer pricing penalties for income years commencing on or after 29 June 2013*, Law Administration Practice Statement PS LA 2014/4 *Administration of the penalty imposed under subsection 284-75(3) of Schedule 1 to the Taxation Administration Act 1953* and Law Administration Practice Statement PS LA 2016/2 *Administration of scheme penalties arising from the application of Subdivision 815-A for income years which started on or after 1 July 2004 and before 1 July 2012 (transition period)*. The Commissioner's guidelines on remission of shortfall interest charge are set out in Law Administration Practice Statement PS LA 2006/8 *Remission of shortfall interest charge and general interest charge for shortfall periods*.

- d. any proposal for resolution of relevant open years.<sup>9</sup>

126. Where we reach agreement with you on your transitional arrangements, that agreement will be executed by way of deed and will apply for the duration of the new financial arrangements, subject to any critical assumptions agreed to as part of the deed.

### **Related party derivative arrangement risk indicator guide**

127. Determining your risk zone requires you to:

- (a) select the appropriate criteria that applies to you, that is
  - (i) the outbound taxpayer criteria, if you are an Australian ultimate holding company with one or more offshore subsidiaries, or
  - (ii) the inbound taxpayer criteria, if you are an Australian taxpayer that is a subsidiary of an offshore entity
- (b) identify the indicators (set out in the left hand column of the tables at paragraph 133 of this Schedule) relevant to your circumstances, and
- (c) determine your score for each indicator based on the actual conditions applying to your related party derivative arrangement.

128. The indicators are expressed as binary (yes/no) questions. Your score for each indicator is determined by reference to your answer to the question. The relative weighting for the indicators reflects our experience of features which tend to indicate risk.

129. An indicator with a score of 10 or 15 is individually capable of resulting in a risk score outside the green zone.

130. Where you have multiple derivative financial arrangements your risk zone rating will be equal to that of your highest scoring individual arrangement.

131. Your aggregate score for all indicators will determine your risk zone for your derivative financing arrangement as follows:

<b>Risk zone</b>	<b>Aggregate score of</b>
Green zone – low risk	between 0 and 4
Blue zone – low to moderate risk	between 5 and 10
Yellow zone – moderate risk	between 11 and 18
Amber zone – high risk	between 19 and 24
Red zone – very high risk	25 or more

132. An explanation of each risk indicator is given at paragraphs 136 to 164 of this Schedule.

<sup>9</sup> Open years are those within the amendment period.

133. Related party derivative arrangement risk indicator guide:

Compliance review attributes	Outbound				Inbound			
	Score							
	10	3	1	0	1	3	10	15
(i) The entity has made an appropriate functional currency determination/choice where possible.			No	Yes	No			
(ii) The underlying transaction(s) causing the exposure arises in relation to dealing(s) with a related or non-related party on commercial terms.			No	Yes	No			
(iii) There is a history of the relevant type of derivative transaction in question being terminated by the entity or group before its maturity date.		Yes		No		Yes		
(iv) The related party derivative transaction gives rise to periodic net cash flows.		No		Yes		No		
(v) The derivative associated with the underlying transaction is initially with a related party, but it is ultimately backed out to the market to a non-related party dealing at arm’s length to mirror the same terms (note that if ‘yes’ no need to score further for this arrangement – this excludes TRS arrangements).	No			Yes			No	
(vi) There is an exposure for the entity or the group which is only a tax or internal accounting exposure, or an exposure that relates solely to intra-group transactions.	Yes			No			Yes	
(vii) The purpose and the effect of the derivative is to hedge, but not to over hedge, the exposure.	No			Yes			No	
(viii) The derivative triggers a loss without triggering a corresponding gain on the underlying transaction.	Yes			No			Yes	
(ix) The standalone legal entity that entered into the underlying transaction giving rise to the exposure is also the entity entering into the derivative transaction said to hedge this exposure.	No			Yes				No
(x) The transacting entities entering into the derivative transaction have financial substance at the time the derivative was entered into (excluding parental support).	No			Yes				No
(xi) The entities entering into the derivative transactions are hybrid mismatch entities.	Yes			No				Yes
(xii) The related counterparty to the derivative or to the underlying transaction giving rise to the exposure is in a low tax jurisdiction, or is favourably taxed, or is in a tax loss position.	Yes			No				Yes
(xiii) The terms of the derivatives reflect terms that would be found in an equivalent arrangement between non-related parties dealing at arm’s length.	No			Yes				No
(xiv) The derivative has the effect of a partial or full synthetic sale of the underlying asset without triggering a gain for tax purposes.	Yes			No				Yes

Base risk	Score
Green	≤4
Blue	5 to 10
Yellow	11 to 18
Amber	19 to 24
Red	25 or more

## Evidencing your self-assessment of your risk zone

134. The following are examples of the kind of evidence it would be prudent to have easily accessible to minimise the burden of any fact checking, as described in paragraph 37 of this Guideline.

Indicator	Example of evidence
<ul style="list-style-type: none"> <li>operating currency</li> <li>functional currency determination/choice</li> </ul>	<ul style="list-style-type: none"> <li>major sales contracts indicating currencies used</li> <li>contemporaneous records detailing internal hedge accounting elections or evidencing the group's policy concerning the use of derivatives by the Group</li> <li>bank statements</li> <li>industry data (supported by financial statements)</li> </ul>
<ul style="list-style-type: none"> <li>underlying transaction</li> <li>derivative transactions</li> <li>entities to the arrangements</li> </ul>	<ul style="list-style-type: none"> <li>relevant executed legal agreements setting out the terms of the arrangements</li> <li>contemporaneous records, such as Board minutes, indicating the purpose of entering into these arrangements</li> <li>internal documents and submissions covering the origination of each derivative and underlying transaction, such as <ul style="list-style-type: none"> <li>internal documents originated by the relevant business unit or risk management assessments</li> <li>submissions made to and sign offs by the various administration areas of the Group including accounting, tax, risk management and corporate governance</li> <li>submissions made to and approvals by the Board</li> <li>copies of documents created by outside parties (accounting firms, law firms)</li> </ul> </li> </ul>
<ul style="list-style-type: none"> <li>cash flow</li> </ul>	<ul style="list-style-type: none"> <li>bank statements</li> <li>cash flow statements (supported by financial statements)</li> </ul>
<ul style="list-style-type: none"> <li>counterparty jurisdictions</li> <li>counterparties tax loss positions</li> </ul>	<ul style="list-style-type: none"> <li>evidence of jurisdiction of incorporation or registration (or other evidence of central management and control)</li> <li>copies of the recent prior tax returns lodged and assessments received in that jurisdiction</li> </ul>
<ul style="list-style-type: none"> <li>financial substance</li> </ul>	<ul style="list-style-type: none"> <li>copies of the recent prior tax returns lodged and assessments received in that jurisdiction</li> <li>copies of annual reports prepared for the year in question</li> </ul>
<ul style="list-style-type: none"> <li>hybrid entities</li> </ul>	<ul style="list-style-type: none"> <li>evidence of registration under the relevant legislation in the jurisdiction of incorporation</li> <li>Constitutions (or equivalent legal agreements) of the parties to the related party derivatives</li> </ul>
<ul style="list-style-type: none"> <li>arrangements are mispriced to the market</li> </ul>	<ul style="list-style-type: none"> <li>comparable evidence in the market</li> <li>comparable executed legal agreements</li> </ul>

## Definition

### Derivatives

135. 'Derivative' in this context is as defined in the accounting standard AASB 139 and includes embedded derivatives. The derivative (excluding total return swaps) must relate to a financing arrangement (the underlying transaction) and be with a related party.

## Indicators

### ***(i) The entity has made an appropriate functional currency determination/choice where possible***

136. A 'functional currency determination/choice' in this context refers to both accounting functional currency and tax functional currency.

137. An 'appropriate' functional currency determination is one which complies with the Australian accounting standards. If a tax functional currency choice has not been made and this does not make commercial sense other than from a tax perspective, we would not consider this to be appropriate.

### ***(ii) The underlying transactions causing the exposure arises in relation to dealings with a related or non-related party on commercial terms***

138. This indicator requires you to identify the counterparty to the underlying transaction which was entered into that caused you to be exposed to a certain market risk. Where the counter party is not related then the question would only apply to a transaction involving a TRS.

139. 'Underlying transaction' refers to the transactions, arrangements or contracts entered into which give rise to the identified hedged exposure.

140. 'Commercial terms' refers to the commerciality of the transactions or arrangements and the commercial outcomes produced by entering into these transactions or arrangements (is the transaction arm's length).

### ***(iii) There is a history of the relevant type of derivative transaction in question being terminated by the entity or group before its maturity date***

141. Answer yes if you or your group has previously terminated one or more similar kinds of derivative arrangements prior to the full term of the arrangement in the last seven years. This does not include internal derivatives which have been backed out to the market on mirror terms where the underlying exposure being hedged also ceases.

142. For the avoidance of doubt, termination in this context also does not extend to taking an equal and opposite derivative position to close off an entity's current derivative position.

143. The Commissioner considers the early termination of a derivative arrangement in any future year, after you have self-assessed your derivative arrangement against this Schedule, to be an exceptional circumstance as detailed in paragraph 41 of this Guideline.

144. For example, if you rate a derivative arrangement as green for a particular year, but you terminate the derivative early, we reserve the right to apply compliance resources to review your related party derivative arrangement.

### ***(iv) The related party derivative transaction gives rise to periodic net cash flows***

145. Answer yes if your related party derivative arrangement actually results in the periodic payment or receipt of cash or periodic net cash flows.

146. Answer no if the cash used in financing the net cash flow from the arrangement was funded via a payment in kind, a subscription of shares or additional debt creation.

***(v) The derivative associated with the underlying transaction is initially with a related party, but it is ultimately backed out to the market to a non-related party to mirror the same terms***

147. This indicator requires you to identify your relationship with the counterparty to the derivative arrangement and determine whether the counterparty, if it is a related party, has entered into a subsequent back-to-back derivative arrangement with a non-related party in the market, dealing at arm's length, to mirror the same terms. Dealing at arm's length in this context can be determined in the light of whether the external transaction entered into would be considered contrived by an objective observer.

148. A derivative is considered traceable to a third party when:

- the derivative entered into between your related party (or other group member) and a non-related third party mirror the key terms, conditions and events (including the start date of the arrangement, currency, swap rates, and cash flows) of the related party derivative entered into by you, and
- the group's accounting system can demonstrate that the appropriate amount of cash flow being provided to your related party (or other group member) by you is the same amount provided to the non-related third party.

If your transaction under review satisfies all the above conditions (Yes) then the arrangement does not have to be scored any further under this Schedule and the arrangement being scored will only be in the green or blue zone as scored for indicators (i) to (v) (see paragraph 115 of this Schedule). Note that this excludes arrangements involving total return swap transactions.

149. Answer no if the counterparty to your derivative arrangement is a related party and the derivative is not traceable to a non-related third party.

***(vi) There is an exposure for the entity or the group which is only a tax or internal accounting exposure, or an exposure that relates solely to intra-group transactions***

150. 'Exposure' in this context refers to the economic variables associated with:

- (a) translational risk (balance sheet risk)
- (b) transactional or commitment risk (income statement risk), and
- (c) economic, operation or competitive risk.

151. Answer yes if your hedge is not being used to manage balance sheet exposure or cash flow exposure of the group (excluding taxation); but rather the derivative is said to hedge or offset an exposure which arises in connection with:

- (a) a transaction between group members, or
- (b) taxation or accounting exposure caused by the intra-group transactions (for example, the hedging of a potential tax exposure relating to foreign currency movements on repayment of a related party loan).

***(vii) The purpose and the effect of the derivative is to hedge, but not to over hedge, the exposure***

152. The derivative is said to hedge an identified exposure if:

- (a) the Australian taxpayer entity is entering into the derivative in order to hedge an exposure
- (b) the derivative entered into by either the Australian entity or the group effectively hedges this exposure, and
- (c) the derivative is not entered into for speculation or profit-making purposes.

153. Answer no if your derivative financial arrangement is not on similar terms as the underlying transaction or if your derivative financial arrangement over hedges the identified exposure (that is, you are paying way more than required to achieve an effective hedge).

***(viii) The derivative triggers a loss without triggering a corresponding gain on the underlying transaction***

154. Answer yes if the loss on the derivative which hedges the identified exposure is claimed as a deduction in a different income year to the corresponding gain of the underlying transaction.

***(ix) The stand alone legal entity that entered into the underlying transaction giving rise to the exposure is also the entity entering into the derivative transaction said to hedge this exposure***

155. Answer no if the derivative which hedges the identified exposure is entered into or held by a different legal entity to the entity which entered into or holds the underlying transaction producing the identified hedged exposure.

156. For the avoidance of doubt, should the derivative arrangement and the underlying transaction be held by different stand alone legal entities of a consolidated group (or multiple entry consolidated group), and there are no legal transfers of risk directly between the standalone legal entities, answer no to this question.

***(x) The transacting entities entering into the derivative transaction have financial substance at the time the derivative was entered into (excluding parental support)***

157. Financial substance in this context refers to the ability to meet any adverse financial settlement associated with the derivative.

158. For the avoidance of doubt, the provision of security by a related party through such instruments as a pledge, providing a guarantee, covenants, parental support and the like are not regarded as providing the entity holding the derivative with financial substance.

159. Answer no if at the time you entered into the derivative arrangement, either you or the counterparty to the derivative arrangement had insufficient ability to honour any adverse financial settlement associated with the arrangement.

***(xi) The entities entering into the derivative transactions are hybrid mismatch entities***

160. Answer yes if you or the counterparty to your derivative is an entity that has inconsistent tax treatment under the laws of two or more jurisdictions.

161. 'Inconsistent tax treatment' includes tax deferral but does not include a simple difference in tax rate between jurisdictions.

***(xii) The related counterparty to the derivative or to the underlying transaction giving rise to the exposure is in a low tax jurisdiction, or is favourably taxed, or is in a tax loss position***

162. Answer yes if the counterparty to your derivative arrangement resides in a jurisdiction with a collective corporate tax rate below 15% (including where there are specific tax holidays or other concessional tax treatments driving the counterparty's tax rate below 15%) or if the counterparty to the your derivative arrangement is in a tax loss position.



**(xiii) The terms of the derivatives reflect terms that would be found in an equivalent arrangement between non-related parties dealing at arm's length**

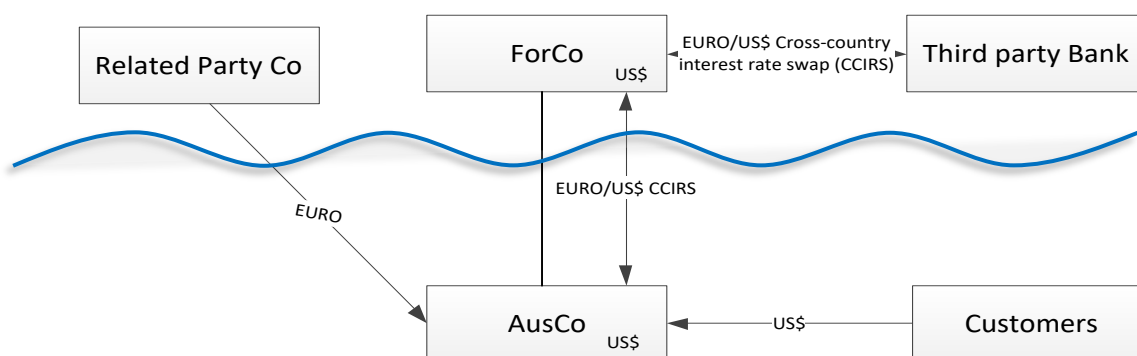
163. Answer no to this indicator if the terms of the derivative with your related counterparty do not reflect terms that would be found in an equivalent arrangement between non-related parties dealing at arm's length (for example, under a cross-currency swap the notional interest rate being paid is higher than what is observed in the market).

**(xiv) The derivative has the effect of a partial or full synthetic sale of the underlying asset without triggering a gain for tax purposes**

164. Answer yes if the effect of the derivative is a transfer of the economic ownership of all or part of the underlying asset (that is, a synthetic sale) and this transfer does not result in an assessable gain for taxation purposes (for example, a total return swap or asset swap).

**Examples of how to determine your risk zone**

**Example 3 – Australian subsidiary of a US oil and gas company**



165. *AusCo Pty Ltd is an Australian subsidiary of ForCo Inc., a company incorporated in the state of Delaware in the US.*

166. *AusCo Pty Ltd is in the oil and gas industry primarily undertaking exploration for, and the extraction of gas. It has an accounting and tax functional currency of US dollars (US\$).*

167. *On 1 January 2017 a related party raised finance in the EURO commercial bond market and then on-lent EURO to Aus Co. The relevant terms of AusCo Pty Ltd's loan and the bond issuance are identical. The terms as set out in the executed legal agreements, were:*

- *interest rate of 1.28% per annum fixed*
- *currency in EURO*
- *principal Euro 2,000,000,000 or equivalent*
- *interest payable quarterly, and*
- *term eight years.*

168. *On 1 January 2017 AusCo Pty Ltd entered into a cross-currency interest rate swap with ForCo Inc. to swap USD fixed for Euro fixed. The relevant terms of this cross currency interest rate swap, as set out in the executed legal agreement are as follows:*

- *AusCo Pty Ltd receives fixed Euro 1.28%*
- *AusCo Pty Ltd pays fixed US\$ 2.21%*

- *principal Euro €2 billion or equivalent*
- *net cash paid quarterly, and*
- *term eight years.*

169. *At the same time, ForCo Inc. entered into a derivative transaction to back out the exposure to the market with a third-party bank that mirrored the arrangement entered into with AusCo Pty Ltd.*

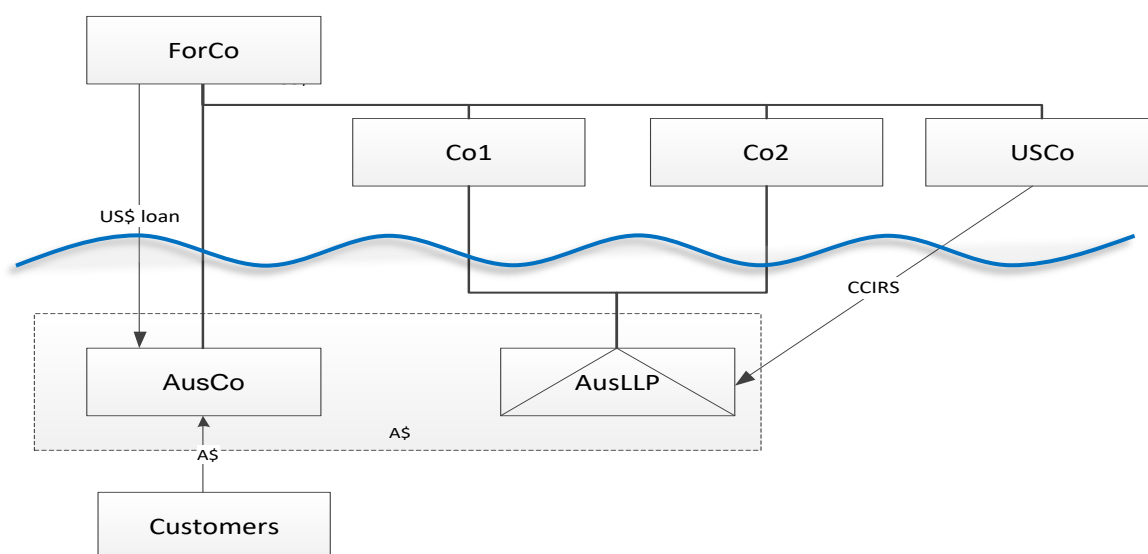
170. *Other key details relevant to the AusCo Pty Ltd and ForCo Inc. group are detailed below:*

- *There is a history of ForCo Inc. and AusCo Pty Ltd terminating cross-currency interest rate swaps prematurely.*
- *The policies of the ForCo Inc. group do not allow hedging for speculative purposes.*
- *The terms of the underlying exposure (the Euro loan from Related Party Co) do reflect terms that would be found in an equivalent arrangement between non-related parties dealing at arm's length.*
- *The periodic payments under the swap and loan are claimed for Australian tax purposes when they are derived and incurred in Australia.*

171. *There is no need to score this arrangement further than the first five indicators ((i) to (v) of the risk indicator guide) for AusCo Pty Ltd as the internal derivative associated with the underlying transaction was ultimately backed out to the market to a non-related party (Third Party Bank) with another derivative that mirrored the same terms.*

172. *AusCo Pty Ltd's risk score for this transaction would be three points. AusCo Pty Ltd had a previous history of prematurely closing out these types of transactions and this attracts three points under indicator (iii). Indicators (i), (ii), (iv) and (v) each score zero points. Therefore, AusCo Pty Ltd's risk rating would likely be in the green zone on this fact scenario. Note if the current transaction is also prematurely closed out then we reserve the right to apply compliance resources to review your related party derivative arrangement (see paragraphs 143 to 144 of this Schedule).*

#### Example 4 – Australian subsidiary of a US automotive company



173. *AusLLP is a limited liability partnership formed in Australia by two subsidiary companies of ForCo Inc.*

174. *ForCo Inc. is a company incorporated in the state of Delaware in the US.*

175. *As a limited liability partnership operating in Australia, AusLLP is treated as an Australian resident company under Division 5A of the ITAA 1936 but still treated as a partnership for US tax purposes.*

176. *AusLLP is the head of the AusLLP tax consolidated group (TCG); this group has an Australian dollar (A\$) functional currency.*

177. *AusCo Pty Ltd is an Australian resident subsidiary of ForCo Inc. and is treated as a member of the AusLLP TCG. AusCo Pty Ltd operates in the automotive industry and is primarily involved in the distribution of automotive parts to the Australian market and derives most of its income in A\$.*

178. *On 1 January 2017, AusCo Pty Ltd received financing from ForCo Inc. The relevant terms of this financing facility to AusCo Pty Ltd., as set out in the executed legal agreement were:*

- *interest rate of 2.21% per annum*
- *currency in US\$*
- *principal US\$2 billion*
- *interest payable quarterly, and*
- *term eight years.*

179. *The ForCo Inc. group's policy is to fully hedge group currency exposures.*

180. *On 1 January 2017, AusLLP entered into a cross currency interest rate swap with USCo, a subsidiary of ForCo Inc., to swap US\$ fixed for A\$ fixed. The relevant terms of this swap, as set out in the executed legal agreement are as follows:*

- *AUSLLP receives fixed US\$ 2.21%*
- *AusLLP pays fixed A\$ 4.2%*

- principal US\$2 billion or equivalent
- net cash paid quarterly, and
- term eight years.

181. Other key details relevant to the ForCo Inc. group are detailed below:

- Members of the ForCo Inc. group have no history of terminating related party cross-currency interest rate swaps prematurely.
- AusLLP accrues its obligations under the swap as the group does not have the means (until parental intervention) to repay the facility.
- The gain or loss of the derivative principal and underlying transaction are claimed when the arrangement matures.
- The periodic payments under the swap and loan are claimed for tax purposes when they are derived and incurred on a tax consolidated basis in Australia.
- The terms of the US\$ loan and the derivative reflect terms that would be found in an equivalent arrangement between non-related parties dealing at arm's length.

182. The risk indicator guide is applied to the circumstances of AusCo Pty Ltd in the following manner:

<b>Pricing indicator</b>	<b>Application of criteria</b>	<b>Score</b>
<b>(i)</b> The entity has made an appropriate functional currency determination/choice where possible.	Yes	0
<b>(ii)</b> The underlying transactions causing the exposure arises in relation to dealings with a related or non-related party on commercial terms.	Yes	0
<b>(iii)</b> There is a history of the relevant type of derivative transaction in question being terminated by the entity or group before its maturity date.	No	0
<b>(iv)</b> The related party derivative transaction gives rise to periodic net cash flows.	Yes	0
<b>(v)</b> The derivative associated with the underlying transaction is initially with a related party, but it is ultimately backed out to the market to a non-related party to mirror the same terms (note that 'yes' means the transaction does not have to be scored further).	No, there is no indication that the arrangement is backed out to the market	10
<b>(vi)</b> There is an exposure for the entity or the group which is only a tax or internal accounting exposure, or an exposure that relates solely to intra-group transactions.	Yes, the exposure relates to an internal accounting exposure	10
<b>(vii)</b> The purpose and the effect of the derivative is to hedge, but not to over hedge, the exposure.	Yes	0
<b>(viii)</b> The derivative triggers a loss without triggering a corresponding gain on the underlying transaction.	No	0
<b>(ix)</b> The stand alone legal entity that entered into the underlying transaction giving rise to the exposure is also the entity entering into the derivative transaction said to hedge this exposure.	No, the underlying transaction is entered into by AusCo Pty Ltd, but the derivative is entered into by AusLLP	15
<b>(x)</b> The transacting entities entering into the derivative transaction have financial substance at the time the derivative was entered into (excluding parental support).	No, without parental support AusLLP has no way of meeting its	15

	<i>obligation to make periodic payments under the derivative</i>	
<b>(xi)</b> <i>The entities entering into the derivative transactions are hybrid mismatch entities.</i>	<i>Yes, AusLLP is a hybrid entity that is treated as a company in Australia but a partnership in the US</i>	<i>15</i>
<b>(xii)</b> <i>The related counterparty to the derivative or to the underlying transaction giving rise to the exposure is in a low tax jurisdiction, or is favourably taxed, or is in a tax loss position.</i>	<i>No</i>	<i>0</i>
<b>(xiii)</b> <i>The terms of the derivatives reflect terms that would be found in an equivalent arrangement between non-related parties dealing at arm's length.</i>	<i>Yes, the terms of the derivative have been found to be at arm's length</i>	<i>0</i>
<b>(xiv)</b> <i>The derivative has the effect of a partial or full synthetic sale of the underlying asset without triggering a gain for tax purposes.</i>	<i>No</i>	<i>0</i>
<b>Total</b>		<b>65</b>

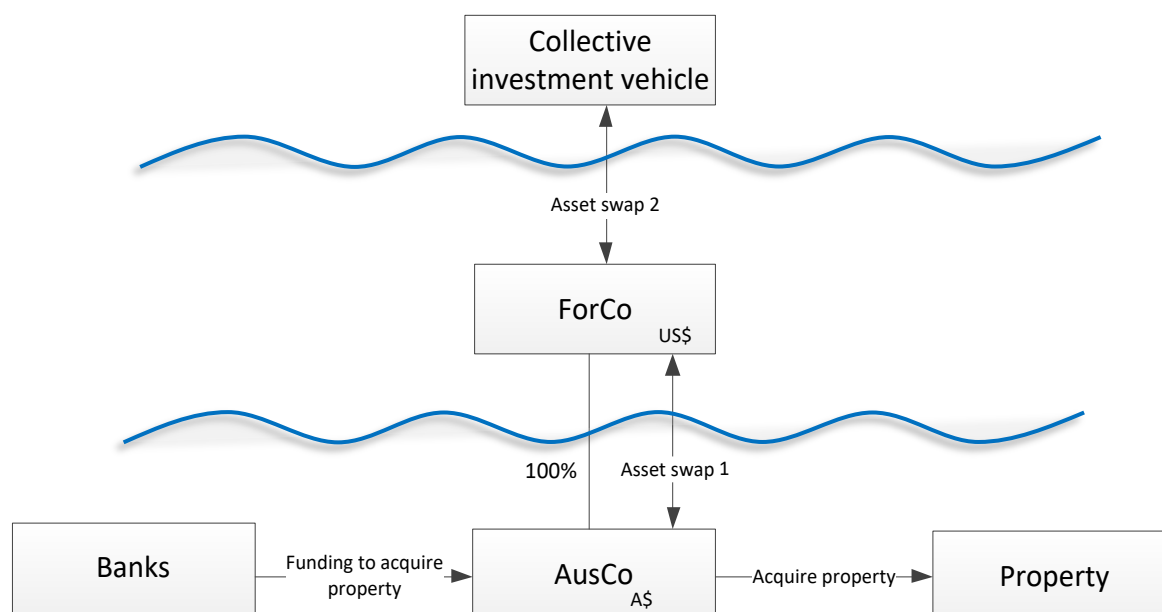
*The AusLLP TCG falls into the red 'very high risk' zone. AusLLP TCG can expect priority compliance activity.*

183. *The AusLLP TCG would likely be in the blue zone if:*

- AusCo Pty Ltd was the entity hedging the exposure*
- the parties to the derivative arrangement had financial substance*
- there was not a hybrid mismatch entity, and*
- there was a real economic exposure to the group other than merely tax or accounting.*

184. *The transaction would likely be in the green zone if the exposure to the group was removed via a hedge with an external party in the market on mirror terms as that of the internal derivative.*

### Example 5 – Australian subsidiary of a US asset management company



185. AusCo Pty Ltd is an Australian subsidiary of ForCo Inc., a company incorporated in the state of Delaware in the US. ForCo Inc. has not 'checked the box' for AusCo Pty Ltd so therefore AusCo Pty Ltd is not fiscally transparent for US tax purposes.

186. AusCo Pty Ltd is in the infrastructure and property development industry, primarily involved in the investment and development of commercial properties in Australia. It has an accounting and tax functional currency of A\$.

187. On 1 January 2015, AusCo Pty Ltd entered into a loan with third-party banks to fund the acquisition and development of the property.

188. On 1 December 2015, AusCo Pty entered into a total return asset swap with ForCo Inc. The relevant terms of this swap for ForCo Inc. as set out in the executed legal agreements are as follows:

- ForCo Inc. receives gross rent from the Property in A\$
- ForCo Inc. pays all property expenses in A\$
- ForCo Inc. pays the equivalent of the BBSW plus a margin
- ForCo Inc. pays/receives the difference in the value of the property at the termination of the asset swap
- ForCo Inc. receives an option to acquire the property from AusCo, and
- the term of the derivative is five years.

189. ForCo Inc. subsequently entered into a second total return asset swap with an unrelated overseas collective investment vehicle (CIV) in another tax jurisdiction with the same terms except a premium was also paid to ForCo Inc. by the CIV when entering into the second total return asset swap.

190. The risk indicator guide is applied to the circumstances of AusCo Pty Ltd as follows:

Pricing indicator	Application of criteria	Score
(i) The entity has made an appropriate functional currency determination/choice where possible.	Yes	0
(ii) The underlying transactions causing the exposure arises in relation to dealings with a related or non-related party on	Yes	0

<i>commercial terms.</i>		
<b>(iii)</b> <i>There is a history of the relevant type of derivative transaction in question being terminated by the entity or group before its maturity date.</i>	No	0
<b>(iv)</b> <i>The related party derivative transaction gives rise to periodic net cash flows.</i>	Yes	0
<b>(v)</b> <i>The derivative associated with the underlying transaction is initially with a related party, but it is ultimately backed out to the market to a non-related party to mirror the same terms (note that even if the answer is 'yes' the transaction still needs to be scored further as it is a TRS)</i>	No, the second TRS has a premium	10
<b>(vi)</b> <i>There is an exposure for the entity or the group which is only a tax or internal accounting exposure, or an exposure that relates solely to intra-group transactions.</i>	No	0
<b>(vii)</b> <i>The purpose and the effect of the derivative is to hedge, but not to over hedge, the exposure.</i>	No, the swap is ultimately entered into for profit making purposes and not to merely hedge the exposure	10
<b>(viii)</b> <i>The derivative triggers a loss without triggering a corresponding gain on the underlying transaction.</i>	No	0
<b>(ix)</b> <i>The stand alone legal entity that entered into the underlying transaction giving rise to the exposure is also the entity entering into the derivative transaction said to hedge this exposure.</i>	Yes	0
<b>(x)</b> <i>The transacting entities entering into the derivative transaction have financial substance at the time the derivative was entered into (excluding parental support).</i>	Yes	0
<b>(xi)</b> <i>The entities entering into the derivative transactions are hybrid mismatch entities.</i>	No, AusCo is not fiscally transparent for US tax purposes	0
<b>(xii)</b> <i>The related counterparty to the derivative or to the underlying transaction giving rise to the exposure is in a low tax jurisdiction, or is favourably taxed, or is in a tax loss position.</i>	No	0
<b>(xiii)</b> <i>The terms of the derivatives reflect terms that would be found in an equivalent arrangement between non-related parties dealing at arm's length.</i>	No, the terms of the derivative have not been found to be at arm's length	15
<b>(xiv)</b> <i>The derivative has the effect of a partial or full synthetic sale of the underlying asset without triggering a gain for tax purposes.</i>	Yes, the total return results in the synthetic sale of the property without triggering a gain for tax purposes	15
<b>Total</b>		<b>50</b>

191. AusCo Pty Ltd falls into the red 'very high risk' zone. AusCo Pty Ltd can expect priority compliance activity.

192. AusCo Pty Ltd would likely be in the green zone if it did not enter into the total return asset swap but instead entered into a direct sale of the property to ForCo Inc. or the CIV at an arm's length market price.

## Amendment history

Date of amendment	Part	Comment
27 November 2019	Schedule 2	Schedule 2 – Related party derivative arrangements finalised.
24 January 2019	Whole document	Minor amendments made throughout document to improve clarity from feedback. Minor amendments made to correct errors.
1 August 2018	Schedule 2	Schedule 2 added and published as draft for comment.
13 June 2018	All	Minor formatting corrections.
	Schedule 1	Inserted paragraphs 93A and 93B.
2 February 2018	Whole document	Minor amendments made throughout document to improve clarity. Minor amendments made to correct errors.

## References

ATOlaw topic(s)	International issues ~~ Cross border financing ~~ Other
Legislative references	ITAA 1936 Pt IVA ITAA 1936 318 ITAA 1997 230-15(2) ITAA 1997 Div 815 ITAA 1997 Subdiv 815-B ITAA 1997 Div 820 ITAA 1997 820-39 ITAA 1997 Div 974 ITAA 1997 960-555 ITAA 1997 960-555(2)(a) ITAA 1997 995-1 TAA 1953 Sch 1 Div 280 TAA 1953 Sch 1 Div 284 TAA 1953 Sch 1 Subdiv 284-E
Related Rulings/Determinations	MT 2008/1 MT 2012/3 TR 2014/8
Other references	PSLA 2006/8 PSLA 2012/5 PSLA 2014/2 PCG 2017/2 <u>Dispute or object to an ATO decision</u> <u>Independent review of the Statement of Audit Position for groups with a turnover greater than \$250m</u> <u>Taxpayer alerts</u>
ATO references	1-BAPMBWJ; 1-7N0J6Z1
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