



**Australian Government**  
**Australian Taxation Office**

# ATO Submission to the Senate Economics Reference Committee

Inquiry into corporate tax avoidance and minimisation and  
Australia's offshore oil and gas industry

30 March 2017

# Contents

<b>Introduction</b>	<b>3</b>
Review of the Petroleum Resource Rent Tax	3
<b>Oil and gas tax landscape</b>	<b>4</b>
Industry context	4
Income Tax	8
Indirect taxes	10
Petroleum Resource Rent Tax	12
Royalties	13
Observations on tax projection models	13
<b>Administration and assurance</b>	<b>15</b>
Our Assurance Approach	15
Specific Energy and Resources Strategy	15
<b>Tax focus areas relevant to the offshore oil and gas industry</b>	<b>17</b>
Exploration expenditure issues	17
Supply chain issues	18
Related party financing issues	19
<b>Appendix A</b>	<b>21</b>
Detailed discussion of areas of focus	21

# Introduction

1. On 1 December 2016, the Senate Economics Reference Committee (the committee) resolved to broaden the scope of the corporate tax avoidance and minimisation inquiry to include Australia's offshore oil and gas industry. The committee requested submissions by corporations involved in Australia's offshore oil and gas industry, including matters relating to the collection of moneys by the Government. In particular, the committee was seeking submissions on the treatment and/or payment of, royalties, petroleum resource rent tax (PRRT), deductions and other taxes.
2. The Australian Taxation Office (ATO) provided a submission to the committee on 2 February 2015, however we are taking this opportunity to provide a specific submission to the committee in relation to the oil and gas industry. This submission provides an overview of the tax contribution made by participants from Australia's oil and gas industry. It also explores the key areas that we are currently focusing on in assuring the taxation affairs of industry participants.

## Review of the Petroleum Resource Rent Tax

3. On 30 November 2016, the Treasurer the Honourable Scott Morrison announced a review into the design and operation of the PRRT, crude oil excise and associated Commonwealth royalties. The review is being led by independent expert Michael Callaghan, with the support of a Secretariat within the Commonwealth Treasury.
4. The ATO made a detailed public submission to the PRRT review on 3 February 2017. Accordingly, this submission does not address matters which are covered or currently under consideration as part of the PRRT review.
5. A copy of our PRRT review submission has been provided as a supplementary submission to this inquiry for information.

# Oil and gas tax landscape

6. The ATO is responsible for the administration of a number of different taxes relevant to the offshore oil and gas industry including:
  - Income tax;
  - Goods and services tax;
  - Fuel tax; and
  - Petroleum resource rent tax.
7. In this section of the submission, we briefly summarise the application of each of these heads of taxation as relevant to the offshore oil and gas industry.

## Industry context

8. At the outset, it is important to note that the companies participating in the offshore oil and gas industry are “in the tax system”, they have formalised tax governance frameworks and controls, they lodge their returns on time, they include all income booked in their Australian entities in their tax returns and they pay their tax debts when due.
9. In analysing the application of the various heads of taxation, it is useful to quickly summarise at a high level the state of the industry over the past five years.
10. There has been significant investment in Australia’s offshore oil and gas projects in recent years. A snapshot of some of the major projects coming online, the estimated cost and capacity, and estimated employment expenditure can be seen in table 1 below.

**Table 1: Snapshot of Australia's major offshore oil and gas projects already in production or close to production.<sup>1</sup>**

Oil and gas project	Start-up / expected	Updated cost estimate (A\$ b)	Estimated new capacity (Mt)	Construction employment estimate (A\$ b)	Operating employment estimate (A\$ b)
<b>Gladstone LNG</b>	2015	21.2	7.8	5	1
<b>Gorgon (train 4)</b>	2020	10+	5.2	n/a	n/a
<b>Gorgon LNG</b>	2016	60	15.6	10	0.3
<b>Ichthys LNG</b>	2017	42.5	8.9	4	0.7
<b>Prelude</b>	2017	12.6	3.6	n/a	n/a
<b>Wheatstone</b>	2017	44.7	8.9	5	.4

11. It can be seen from the table 1 that offshore oil and gas projects have significant construction costs requiring significant investment by the industry.
12. Whilst the table shows significant employment costs during the construction phase these costs fall markedly when construction has been completed. It's worth noting that employing entities will have pay as you go withholding (PAYG) obligations on behalf of their employees for salary and wages paid and this amount will be particularly significant during the construction phase. PAYG amounts withheld will significantly decrease as employment decreases when the projects move to the production phase.
13. Table 2 below shows the market value of oil and gas exports based on current and adjusted forecasted prices. The table shows the significant jump in the value of exports expected as a result of a number of projects coming on line in 2017-2018.

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<sup>1</sup> Office of the Chief Economist, December 2016 project listing data.

**Table 2: oil and gas exports – current and forecasted<sup>2</sup>**

	2013-14	2014-15	2015-16	2016-17 (forecasted)	2017-18 (forecasted)
<b>Oil and gas exports</b>	\$27.4 billion	\$24 billion	\$21.9 billion	\$29.9 billion	\$45.7 billion

14. The growth and expansion of Australia's offshore oil and gas projects has been funded by significant capital injections from offshore, primarily in the form of equity and related party debt injections into Australia. Table 3 provides a snapshot in dollar terms in respect of the investment in eleven of Australia's larger oil and gas producers involved in key offshore upstream projects. Although the data only reflects ten participants, this table provides an indication of the capital structure of participants involved in offshore Australian oil and gas projects that for the most part are subsidiaries of foreign multinationals.

**Table 3: Investment in Australia's offshore oil and gas projects as per annual reports<sup>3</sup>**

		2012-13	2013-14	2014-15	2015-16
<b>Population</b>	No.	11	11	11	11
<b>Issued Capital</b>	\$m	40,816	44,352	49,228	65,286
<b>Total Assets</b>	\$m	136,186	170,229	191,304	209,693
<b>Total Debt</b>	\$m	54,938	78,503	101,074	112,669
<i>Related Party Debt</i>	<i>\$m</i>	<i>51,887</i>	<i>74,127</i>	<i>94,570</i>	<i>106,580</i>
<i>Third Party Debt</i>	<i>\$m</i>	<i>3,050</i>	<i>4,375</i>	<i>6,505</i>	<i>6,088</i>

15. As can be seen from the table there has been a significant increase in assets and both debt and equity of these participants. However, debt funding has increased by almost \$55 billion, more than double the approximately \$25 billion increase in issued capital. Further, it can be noted in this table that the debt funding of these participants is almost exclusively via related party funding.

<sup>2</sup> Office of the Chief Economist, Resources and Energy Quarterly, December 2016; Office of the Chief Economist, Resources and Energy Quarterly, December 2015; Office of the Chief Economist, Resources and Energy Quarterly, December 2014.

<sup>3</sup> Where figures have been rounded discrepancies may occur between the sums of the component and their totals.

16. The following table (table 4) is indicative of the increase in interest expense as per the tax returns for participants involved in Australia’s major offshore oil and gas projects (other than those businesses with diversified businesses).

**Table 4: Interest expenses of participants in Australia’s offshore oil and gas as per income tax return disclosures**

		2011-12	2012-13	2013-14	2014-15	2015-16 <sup>4</sup>
<b>Interest expense within Australia</b>	\$m	457	270	168	131	170
<b>Interest expense overseas</b>	\$m	1,735	1,776	1,539	1,759	2,387

17. This table shows the interest expense disclosed by relevant companies in the specific interest expense disclosure in their income tax return. It indicates that since 2013-2014 interest expense to overseas parties has been increasing with a significant increase in the 2015-2016 income tax year of almost \$500 million, but not at the same rate of increase as related party debt, implying a lower average interest rate being charged on that related party debt.
18. It is important to note that the table significantly understates the amount of related party interest contractually payable, which we estimate to be circa \$3.9 billion in the 2015-16 year. There are two key reasons. The first is that some companies capitalise interest for accounting purposes in the construction / development phase, and so do not have an accounting interest expense (which is what is required to be disclosed in the tax return). The second is that some companies have self-assessed a denial of deductions for related party interest, and so have not reported that component of interest expense in their tax return. For completeness, it should also be noted that some companies have entered into related party derivatives under which they pay interest equivalent amounts, but do not treat those payments as interest for tax return disclosure purposes.
19. Given the judgment that would be required in making adjustments, the small number of relevant taxpayers and the fact that single company adjustments may have overall significant effects, the table above has simply been produced based on the income tax return disclosures, and so the interest expense

<sup>4</sup> Some income tax returns have not yet been lodged for this year, therefore the figures may be incomplete.

amounts should only be taken as an indication of trend rather than absolute amounts.

20. Interest paid overseas to related parties will generally be subject to withholding tax. Rates can vary according to the jurisdiction, but is commonly 10%.<sup>5</sup>
21. Australia also has a number of other projects which remain under consideration by various participants. Should these projects go ahead, the investment in Australia's oil and gas projects will rise significantly.

## Income Tax

22. For the purposes of this submission we have included the tax performance data of participants that hold an interest (directly or indirectly if the project is held by an incorporated joint venture) in Australia's major offshore oil and gas projects.
23. Income tax cash collections are reported on a taxpayer basis and are not based on industry segmentations. Therefore, the income tax data for participants in this industry reflects a range of activities both onshore and offshore and is not limited to the tax performance of the offshore projects. Taxpayers with diversified businesses that earn significant income outside of the oil and gas industry have been excluded from the population.
24. Separately, the ATO has published corporate tax data in relation to the 2013-2014 and 2014-2015 years in relation to some industry participants that meet the threshold tests for that disclosure (usually \$100m of gross revenue). Apart from this disclosure, the ATO cannot provide information at a taxpayer level, or at a level where a particular taxpayer's affairs could be identified.
25. Table 5 below provides a summary of the tax performance for the defined population.

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<sup>5</sup> It should be noted that this table also does not include interest equivalent amounts paid under cross currency interest rate swaps, which some participants have entered into with related parties, often to convert a legal form USD borrowing into a synthetic AUD borrowing – refer Taxpayer Alert 2016/3.



**Table 5: Tax data for 2012 to 2016 income tax years<sup>6</sup>**

		2011-12	2012-13	2013-14	2014-15	2015-16 <sup>7</sup>
<b>Number of economic groups</b>	No.	32	32	32	32	32
<b>Net profit / loss per year<sup>8</sup></b>	\$m	9,348	10,825	6,692	-11,140	-11,749
<i>Profit reported</i>	\$m	10,603	12,760	9,420	7,409	4,750
<i>Loss reported</i>	\$m	-1,255	-1,935	-2,728	-18,550	-16,499
<b>Net Taxable Income</b>	\$m	4,189	6,982	1,880	-304	-7,419
<i>Taxable income reported</i>	\$m	6,417	8,645	5,508	6,931	3,540
<i>Net tax loss reported</i>	\$m	-2,227	-1,662	-3,627	-7,235	-10,959
<b>Tax losses deducted</b>	\$m	413	422	667	1,982	290
<b>Income tax payable</b>	\$m	1,883	2,368	1,483	1,622	547
<b>Revenue losses carried forward</b>	\$m	13,160	13,981	17,685	24,052	34,436
<b>Net capital gains tax reported</b>	\$m	691	5,108	54	4,699	18

26. As can be seen from the data there has been a significant decline in net profit and consequently income tax payable over the period. Further, there has been a substantial increase in carry forward losses which have more than doubled since the 2012 income tax year. Two key factors are contributing to this.

27. Firstly, historically the performance of some of these groups reflected their downstream operations, which were generally profitable. Many participants have since divested their downstream operations and concentrated on upstream operations. Related to this, as will be noted from table 5, there have been significant capital gains reported by industry participants over the 2012 to

<sup>6</sup> Data current as at 27 March 2017. Where figures have been rounded discrepancies may occur between the sums of the component and their totals.

<sup>7</sup> Some income tax returns have not yet been lodged for this year therefore the figures may be incomplete.

<sup>8</sup> Based on income tax return disclosures of income and expenses (not statutory account information).

2016 years. This reflects that many participants in this industry have changed their business models over the period.

28. Secondly, the life cycle of the projects is such that it is usual to expect that participants would incur significant tax losses. At the early stages of an offshore gas project, significant carry forward tax losses will typically be generated due to investment in exploration (deductible when incurred), construction and development (usually depreciable over time) and financing costs (deductible when incurred), with no offsetting income at that stage.
29. The projects only start earning assessable income once they move into the production phase. A project would typically not have taxable income until several years after commencement of production, ie until carried forward losses of the earlier years are fully utilised. Carry forward losses may also be used to shelter tax payable on pre-existing profitable projects which are later in their life cycle. As such, given the current stage of many of these projects (having just commenced significant production), they would not be expected to be tax payable at this time.

## Indirect taxes

### Goods and services tax

30. Under the Goods and Services Tax (GST) regime, exports are GST free. This means that exporters will typically receive refunds for input tax credits on acquisitions without remitting GST on exported sales. The position for an exporter in the oil and gas industry is consistent with that of an ordinary exporter.
31. Significant expenditure is incurred during the construction phase of each project and therefore the GST paid on that expenditure may result in material input tax credits being claimed and subsequently refunded. Given that a typical project is conducted as a GST joint venture this means that GST reporting is not done on an individual project basis. Joint venture operators will report for all the GST joint venture projects they are responsible for. However, as a joint venture operator may report for multiple projects, it is difficult to identify amounts specific to individual projects.
32. Typically, the oil and gas from offshore projects is exported and therefore does not attract GST. Each participant in a GST joint venture is responsible for

reporting its share of the supplies made from the project. GST is applied to any output which is supplied into the domestic market.

## Fuel tax credits

33. Operators of offshore projects may be entitled to fuel tax credits for the fuel tax, excise or customs duty that is included in the price of fuel used in carrying on the project. Fuel tax credits provide a mechanism for reducing or removing the incidence of excise or customs duty included in the price of fuel used when the fuel is used in certain activities.
34. Fuel tax credits are able to be claimed for taxable fuel (such as diesel or gaseous fuels subject to duty) acquired, manufactured or imported into Australia for use in machinery, plant, equipment, transport and shipping vessels. In the oil and gas industry fuel tax credits typically arise from using taxable fuel in:
- generating power to run a large range of processes and accommodation for workers;
  - equipment for oil and gas extraction; separation; compression; waste water treatment; delivery by pipeline to shore (or export to tanker) and water desalination;
  - vessels servicing offshore installations and also heavy vehicles on roads transporting equipment/output; and
  - building and constructing extraction facilities.
35. Fuel tax credits are typically claimed by the operators of offshore oil and gas projects in a similar manner to GST obligations. As fuel tax credits are reported and claimed by operators it is difficult to accurately determine the amount of fuel tax credits claimed specifically for individual offshore oil and gas projects. However, we estimate that approximately \$300 million<sup>9</sup> of fuel tax credits have been claimed by the operators of major projects from 2012 to 2016.
36. Where companies receive fuel tax credits, that amount received will be included as assessable income for income tax purposes.
37. There are no known endemic risks specific to oil and gas for fuel tax credits in these offshore activities.

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<sup>9</sup> This does not include claims made by operators of smaller projects, contractors on those projects and other entities associated with infrastructure and other support services.

38. Crude Oil Excise applies to crude oil and condensate produced onshore and within the offshore areas of the North West Shelf exploration permits. Only certain offshore producers within those exploration permits (where the relevant thresholds have been exceeded) currently pay this excise.
39. The excise applies regardless of whether crude oil and condensate is exported or for domestic use. No onshore areas have exceeded the relevant thresholds and so no Crude Oil Excise has been paid in relation to onshore areas.
40. The following table shows the collections for Crude Oil Excise and condensate between the 2012 to 2015 financial years. The decline in Crude Oil Excise in more recent times is largely due to the reduction in world oil prices.

**Table 6: Crude Oil Excise Collections between the 2012-15 financial years**

		2011-12	2012-13	2013-14	2014-15
Excise Revenue for Crude and Condensate	\$m	853	833	773	518

41. For further details of the Crude Oil Excise, please refer to Part B of our submission made to the PRRT Review.

## Petroleum Resource Rent Tax

42. The ATO is responsible for administering the PRRT. An entity will be liable to pay PRRT where that entity earns a taxable profit in relation to a petroleum project.
43. An entity paying PRRT in a financial year will be entitled to a deduction for income tax purposes in that year. Conversely, where an amount of PRRT is refunded, the entity will include that amount as part of their assessable income for income tax purposes.
44. In 2015-16, PRRT accounted for \$845 million of the \$343 billion in taxes collected by the ATO. Table 6 sets out the key PRRT statistics for the 2012 to 2016 financial years.
45. For a more detailed discussion of the PRRT, please refer our submission made to the PRRT Review.

**Table 7: PRRT statistics for the 2012-16 financial years**

		2011-12	2012-13	2013-14	2014-15	2015-16
Number of PRRT returns	No.	75	155	148	149	148
Assessable receipts	\$m	12,709	26,319	29,643	25,537	20,111
Taxable profit	\$m	3,961	3,203	4,468	3,052	2,114
PRRT Tax rate	%	40	40	40	40	40
<b>PRRT tax paid on taxable profit</b>	<b>\$m</b>	<b>1,584</b>	<b>1,281</b>	<b>1,787</b>	<b>1,221</b>	<b>845</b>

## Royalties

46. Royalties may be payable to either the Australian Government or the states/territories depending on where the extraction of oil and gas takes place.
47. The Australian Government is responsible for developments in all areas seaward of three nautical miles from the territorial sea baseline, which is known as Commonwealth waters. The state and territory governments are responsible for developments between the Commonwealth waters and the territorial sea baseline (coastal waters) and on land.
48. The ATO is not responsible for administering these oil and gas extraction royalty regimes. Entities required to pay royalties to the states/territories will pay those amounts directly to the responsible state/territory whilst royalties payable to the Australian Government are administered and collected by the Department of Industry, Innovation and Science. For details of the quantum of royalties collected by the Commonwealth, refer to *Review of the Petroleum Resource Rent Tax, Issues Note*, 20 December 2016, part 2.1.3.

## Observations on tax projection models

49. In some cases, often at the inception of a project, companies have produced models which project the anticipated future tax revenues to arise from their investment in Australian oil and gas projects, sometimes at a taxpayer level, sometimes at a project level. In comparing the tax projection models of entities participating in Australia's offshore oil and gas industry to the actual tax outcomes of projects, a variety of factors may explain why the project level projections made on initiation of a project are difficult to reconcile with or differ

from actual tax payments. Reasons for these differences can be tied to commercial, economic and tax specific reasons.

50. Commercial drivers that create a difference between projected tax payments and actual tax payments include:
- Delays in the finalisation of construction and therefore production coming from some projects;
  - Significant over runs on construction costs of some projects; and
  - Oil and gas prices used in original modelling are significantly higher than current global prices (refer economic factors immediately following).
51. Economic factors, both domestic and global, have affected these projections (particularly as to prices) and hence actual tax payments. These include:
- The industry currently being in state of over supply with more trains coming online soon;
  - All price indices are considerably lower than expected with the forecast showing that they may stay this way for a period of time in to the future; and
  - The United States of America transitioning from a net importer of LNG to a net exporter of LNG as result of the shale gas boom.
52. There may also be tax specific drivers such as:
- Models aggregating multiple taxes and royalties into a single “tax contribution” line;
  - Models focusing on tax at a notional project level, when taxes are paid by individual participants in a project, meaning that taxes paid by all participants need to be aggregated to compare “apples with apples”.
  - Models not including participant level deductions, particularly deductions for cost of finance, particularly interest on related party debt; and
  - Models including all revenue from the project as taxable, when subsequently some functions and profits are shifted to marketing, trading or other forms of hub in other jurisdictions (i.e. outside the Australian tax base) by some or all participants.

# Administration and assurance

## Our Assurance Approach

53. We have provided a detailed overview of our approach to compliance in the ATO Submission – Senate Economics Reference Committee, *Inquiry into corporate tax avoidance and minimisation*, 2 February 2015.
54. Our administration of the corporate tax system is based on co-operative compliance to support willing participation. The ATO takes a prevention over correction approach. Actively preventing structures or transactions that pose a risk to the corporate tax base before they are contemplated will reduce compliance costs for taxpayers and provide greater certainty for all stakeholders.
55. As part of this approach, the ATO issues taxpayer alerts to flag behavioural choices, transactions and arrangements that concern us. These taxpayer alerts are designed to share our concerns early to assist corporates to make informed decisions about their tax affairs. It is anticipated that by sharing our concerns, we will be able to resolve issues as early and cooperatively as possible.
56. We have also, and will continue to release practical compliance guidelines which provide broad law administration guidance, addressing the practical implications of tax laws and outlining the ATO's administrative approach. These guidelines can provide taxpayers with additional certainty and compliance savings which assists compliance resources to higher risk areas of the law.
57. Given the highly complex commercial and legislative environment in which we operate, differences in view will occur. We will continue to undertake assurance activities on high risk structures, transactions and/or interpretations of the law.

## Specific Energy and Resources Strategy

58. The ATO has an Energy and Resources (E&R) Strategy team which works with internal and external stakeholders to deliver an integrated, co-ordinated and whole-of-taxation approach across the energy and resources sector, including the oil and gas industry.
59. The E&R Strategy team is responsible for:

- developing assurance strategies for Australia’s energy and resources industries, including some of Australia’s major offshore oil and gas projects;
  - developing public guidance products which assist taxpayers with their tax compliance;
  - identifying and treating new and emerging risks across the industry;
  - consulting with industry stakeholder groups to identify and resolve industry based risks; and
  - developing or facilitating learning and development tools and resources to build ATO capability.
60. In early 2016 the E&R strategy team commenced a specific oil and gas project to gain assurance of the tax payable by taxpayers associated with major offshore oil and gas projects. The project is still ongoing.
61. In all, 34 taxpayers are included in the project. Taxpayers were included having regard to their participation in major offshore projects in Australia. Activities were tailored for each taxpayer according to the life cycle of the projects (e.g. whether tax risks arise pre or post lodgement) and tax risks already assured. Some taxpayers may already have been subject to some compliance activity, for example if they were a “key” taxpayer (broadly the ATO categorises the hundred largest taxpayers as “key”, reflecting that these taxpayers pay approximately half of all corporate tax).
62. The project ensures that key risks are being identified and assured consistently within similar timeframes across all taxpayers. Whilst the offshore projects were the basis for selection of the taxpayers, review of the tax risks is not limited to industry or project specific risks emanating from those projects. For example, we have identified exploration and financing as key risks. Exploration would generally be specific to a project however financing may not be but would also be reviewed as part of the assurance process.
63. Ultimately, it is the ATO’s intention to provide the community with the confidence that large businesses involved in Australia’s oil gas projects are paying the right amount of tax.



# Tax focus areas relevant to the offshore oil and gas industry

64. As previously stated, companies participating in the offshore oil and gas industry are broadly compliant.
65. However, from time to time, we have disagreements with some industry participants on the application of particular provisions of the tax laws in relation to their operations. Given the size of the investment by the industry in these operations, these disputes can sometimes be highly significant in terms of absolute liabilities, often running to the hundreds of millions of dollars in tax over several years.
66. Our key areas of focus relevant to Australia's offshore oil and gas industry can be split into three broad areas:
- exploration;
  - supply chain; and
  - related party financing.
67. This section provides an overview of the key areas of focus. Further details of the focus areas have been included in Appendix A.

## Exploration expenditure issues

68. There are two main areas of focus in relation to exploration expenditure:
- Is the expenditure late stage exploration (deductible up front) or early stage development (depreciable over time) and is the taxpayer's filing position consistent with Taxation Ruling TR 2017/1 *Income Tax: deductions for mining and petroleum exploration expenditure*?
  - Are exploration deductions available for amounts paid for purchase of particular mining rights?
69. In respect of the first issue, the ATO has issued a practical compliance guideline PCG 2016/17 *ATO compliance approach – exploration expenditure deductions* to assist taxpayers to self-assess the compliance risk associated with their claims. By following the principles in the guideline taxpayers can improve their confidence, and ours, that

their claims are correct. The ATO conducted extensive consultation with industry in relation to both the Ruling and the guideline.

70. The second issue has largely been dealt with by an amendment to the law preventing immediate deductions for the cost of acquiring mining rights. The amendment applies from 14 May 2013. The ATO is finalising the last of the audits for claims made before the commencement date.

## Supply chain issues

71. The main area of focus in relation to supply chains is in relation to the use of related party marketing or trading hubs, usually in a low tax jurisdiction or in a jurisdiction which offers tax holidays for trading activities. The issue is to ensure that the hub is remunerated appropriately but not excessively for its contribution, not only in the value it creates for the broader organisation, but reflecting how much of that value it would capture if it was an unrelated party dealing with the taxpayer. With the growth in exports in the oil and gas industry, this is an emerging and potentially significant issue.
72. The ATO has issued a practical compliance guideline PCG 2017/1 *ATO compliance approach to transfer pricing issues related to centralised operating models involving procurement, marketing, sales and distribution functions*. The PCG will allow taxpayers to self-assess the compliance risk associated with their hub arrangements, be clear about the compliance risk associated with those claims and understand the action that we may take as a result.
73. There are several other areas of focus:
- Use of “non-core” procurement hubs: a centralised company, usually in a low tax jurisdiction, is used to purchase “non-core” inputs (such as consumables, miscellaneous equipment etc) and on-sells to the Australian entity with a mark-up – is the mark-up excessive?
  - Use of “core” procurement hubs (more relevant for downstream operations than exporting upstream operations): a centralised company, usually in a low tax jurisdiction, is used to purchase “core” inputs such as oil and on-sells to the Australian entity with a mark-up – is the mark-up excessive?
  - Use of shipping hubs: a centralised company, usually in a low tax jurisdiction, is used to either operate ships or procure shipping on the group’s behalf: is the mark-up or profitability of the hub excessive?

74. In relation to the oil and gas industry, which is at an early stage of production, the ATO focus is seeking to ensure that appropriate hub pricing is established from inception of a project, rather than an “after the event” approach which relies on subsequently amending incorrectly priced hub arrangements.

## Related party financing issues

75. Although not industry specific, related party financing issues are of significant importance to the oil and gas industry given the sheer volume of foreign capital recently invested in the industry. There are three sub-issues that the ATO focuses on:
- Whether the interest rate paid to the offshore parent on the debt is excessive?
  - Whether the company is truly within thin capitalisation limits?
  - Whether the company has financed in a way which avoids interest withholding tax?
76. Compliance activity is ongoing in relation to all of these risks. Amended assessments have already issued in respect of some matters and one case is already in court (see *Chevron Australia Holdings Pty Ltd v FC of T* [2015] FCA 1092). The ATO is also currently having settlement discussions with some taxpayers.
77. Taxpayer alerts have already issued for each of these issues to flag our concerns to taxpayers. We are currently developing practical compliance guidelines for related party financing arrangements to provide further certainty to taxpayers.
78. In relation to the interest rate on loans from the offshore parent, a key benchmark is the interest rate payable by the parent group on external debt. If the interest rate charged to the Australian subsidiary exceeds that rate, particularly by more than a nominal margin, the ATO will review the rate to determine whether it represents the rate that the Australian subsidiary, as part of a global group (and not a stand-alone “orphan”) would borrow at from a third party.
79. In practice, the key incentive to charge an excessive interest rate on related party debt is that the interest income of the counterparty is not fully taxed on a current basis in the other country. This can be due to the use of a hybrid

instrument (debt for Australian purposes, tax preferred equity for foreign purposes), the use of hybrid entities (the interest income will often be disregarded for foreign tax purposes) and/or the use of lenders in low tax jurisdictions (often established in a way that “home country” controlled foreign company rules do not apply to “top up” the low tax).

80. In relation to thin capitalisation, there are “safe harbour” debt limits based on a percentage of Australian assets (currently 60%). We have a focus area relating to taxpayers artificially boosting the value of the Australian assets (through revaluations which are not permitted under the thin capitalisation rules) – refer Taxpayer Alert 2016/1. We also have a focus area relating to taxpayers treating a loan as equity for the purposes of the ratio (making it easier to pass) but still claiming the loan as debt for deductibility purposes, subverting the 60% ratio – refer Taxpayer Alert 2016/9.

# Appendix A

## Detailed discussion of areas of focus

### Exploration expenditure

#### **Is expenditure late stage exploration expenditure or early stage development?**

81. Expenditure in the exploration phase can be significant. This is especially true for offshore oil and gas projects where, according to data from the Australian Bureau of Statistics, \$12.3 billion has been spent over the past five years (\$25.6 billion over the last 10 years).<sup>10</sup> As exploration expenditure may be claimed under different provisions, it is not possible to quantify the exploration claims deducted for income tax purposes.
82. Costs incurred for exploration are generally immediately deductible for tax purposes. Owing to the stage in the life cycle of a project when this type of expenditure is typically incurred, exploration costs can give rise to significant “up front” tax losses for participants.
83. Expenditure incurred on exploration or prospecting may be deductible under the general deductibility provision or a specific provision which provides an immediate deduction for costs incurred on exploration and prospecting. Whether a deduction is available under either the general or specific provision will depend on the particular facts and circumstances and the particular requirements of each section. These provisions provide different bases for deductions, but taxpayers cannot obtain more than one deduction for the same amount.
84. Broadly, participants in the Australia’s offshore oil and gas projects can deduct expenditure for exploration activities under the general provision if the expenditure is incurred in carrying on a business and it is not capital in nature (in other words it is not incurred on securing a permanent advantage or asset for that business).
85. Alternatively, an amount may be deductible under the specific provision for a participant if the expenditure is incurred on ‘exploration or prospecting’ and none of the exceptions apply (for example the expenditure is not on development drilling or for working a petroleum field). Under the specific

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<sup>10</sup> Table 6a. PETROLEUM EXPLORATION, Expenditure by onshore and offshore, 8412.0 – Mineral and Petroleum Exploration, Australia, December 2016, last accessed 28 March 2017  
<<http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/8412.0Dec%202016?OpenDocument>>.

provision exploration or prospecting takes an extended meaning and includes what would ordinarily come within the meaning of the words as well as other specifically listed activities that may not ordinarily be considered exploration, such as economic feasibility studies.

86. There are certain circumstances where the ATO is of the view that neither section will be satisfied and therefore expenditure will not be immediately deductible. These circumstances include:
- The cost of long lead items; and
  - The cost of early development activities such as detailed executable engineering and design work from which project assets can be constructed.
87. It is common practice that a joint venture will order “long lead” assets before making a final decision to proceed with the project. As the name suggests these assets take a long time to fabricate or manufacture and therefore, to avoid project delays, joint ventures purchase them ahead of the final commitment to proceed with the project.
88. A joint venture may also commence early works activities such as preliminary site works and detailed engineering and design. This is typically done to retain the workforce during the period when the project is waiting for final investment approval after the completion of the economic feasibility study.
89. It is the ATO’s view that these types of expenditure are not deductible under the general deductibility provision as they are capital in nature, and are not deductible under the specific provision (as these amounts will generally go to the cost of an asset and will be depreciable over the statutory life or effective life of the asset). Further it is the ATO’s view that long lead assets, early works activities and detailed design activities do not come within the ordinary meaning of exploration or prospecting and go beyond what is necessary to consider the economic feasibility of a project.
90. It has been put to the Commissioner that a final investment decision (FID) is a bright line for determining deductibility. The ATO does not accept this position, but acknowledges that factual indicators including level of commitment to proceed to mine or commence a project (which may differ from the FID) may provide further evidence to support that expenditure is on exploration.
91. On 22 February 2017 the ATO released Taxation Ruling TR 2017/1 *Income Tax: deductions for mining and petroleum exploration expenditure* and Practical Compliance Guideline PCG 2016/17 *ATO compliance approach - exploration expenditure deductions*. These guidance products explain the ATO’s view on the deductibility of expenditure on mining and petroleum exploration and

prospecting activities, the relative risk associated with claiming such expenditure and how we will assure any claims to check compliance.

92. The ATO continues to conduct assurance activities in relation to high risk claims.

### **Deductions for the purchase of rights if and when first used for exploration**

93. If an asset is first used for exploration or prospecting, a taxpayer may be able to claim an immediate deduction for the cost of the asset instead of depreciating the cost over the life of the asset (subject to meeting certain criteria and the exceptions not applying). Prior to May 2013, it was also possible for taxpayers to claim an immediate deduction for the cost of acquiring mining rights (such as licences and permits), including amounts attributed to mining information, from another miner.
94. In 2014 the law was amended and an immediate deduction is now only available for a mining right granted by an Australian government body, and certain mining information that is acquired from an Australian government body or a third party that carries on a business of providing mining information, or created by a miner or its contractors. The amendment applies from 14 May 2013, being the date the amendment was announced by the then Treasurer. Mining rights or mining information acquired after this date are deductible over 15 years or the effective life of the right or information, whichever is shorter.
95. Whilst the amendment has prevented the cost of acquiring rights from another miner from being immediately deductible, the ATO is still resolving a small number of claims that relate to the period before the amendment, including claims made by taxpayers in the oil and gas sector. Whether the costs satisfy all elements of the section in order to be immediately deductible is a factually dense and complex inquiry which often takes considerable time and resources to resolve. Whilst we cannot disclose the precise size of these claims for confidentiality reasons, we note that they are material.

## **Supply chain issues**

### **Marketing hubs**

96. As offshore projects enter the production phase, we have observed an increase in export flows (from a tax/legal perspective) with related party sales and marketing hub arrangements. We anticipate that these flows will continue to increase as new projects become operational.

97. While the structure and business models used for hubs vary, the common theme involves the centralisation of various functions relating to the sales of commodities to international customers. These centralised operating models or hubs typically come within one of two broad structures; buy/sell arrangements (where the hub takes legal title to the commodities and makes a margin on the sale) or an agency arrangement (where the hub arranges the sale on behalf of the Australian producer for a fee, usually some form of commission). As these hubs are usually located in offshore low tax jurisdictions (or in jurisdictions which provide tax holidays or other incentives to establish hubs), the insertion of a hub structure into the supply chain results in the allocation of some level of profit to that jurisdiction.
98. Whilst the overall structure of a hub and relevant transaction flows may be driven by commercial decisions, they pose significant profit shifting risks if too much profit is allocated to the hub in the offshore jurisdiction, or in technical terms where the arrangement is not consistent with the arm's length principle in Australia's transfer pricing provisions.
99. Disputes in marketing hub cases arise between the ATO and taxpayers due to disagreements around if the actual arrangements implemented by taxpayers reflect 'arm's length conditions' in terms of actual substance, demonstrating the arrangements are consistent with real commercial behaviour and also pricing.
100. In some cases, the ATO is concerned that having regard to the economically significant features and attributes of some arrangements, including the global value chain and the key profit drivers of the business, it is difficult to conclude that a hypothetical independent enterprise in the position and circumstances of the Australian producer would have entered into the arrangement with an unrelated party. That is, in those circumstances the Australian producer may not have outsourced/contracted the function in a way that it did and subsequently would not have foregone significant amounts of profits to an offshore unrelated party.
101. In other cases, the ATO is concerned that, in a dealing between unrelated third parties, a significant component of the value said to be generated by the hub would be captured by the Australian entity due to relative bargaining positions.
102. In January 2017, the ATO issued Practical Compliance Guideline PCG 2017/1 *ATO compliance approach to transfer pricing issues related to centralised operating models involving procurement, marketing, sales and distribution functions* (Hubs PCG).
103. The guideline is relevant to all offshore hub arrangements however at this stage indicators have only been included for offshore marketing hub arrangements. It



will apply to all taxpayers however it will be of particular relevance to taxpayers in the energy and resources sector including oil and gas exporters.

104. Taxpayers are able to apply the guideline to self-assess the compliance risk associated with their offshore marketing hub arrangements. Taxpayers in the low risk zone are able to obtain certainty that the ATO will not view their arrangements as being at risk of obtaining a transfer pricing benefit. Taxpayers not in the low risk zone are not automatically assumed to have inappropriate transfer pricing arrangements, however they are on notice that they may be subject to further compliance activity commensurate to their risk profile.
105. The additional disclosure requirements set out in PCG 2017/1 will also assist the ATO to monitor the hub arrangements of significant taxpayers over time. The ATO continues to actively review hub arrangements that are considered to pose a risk to the revenue base.
106. Whilst the transfer pricing provisions are the primary mechanism by which the ATO addresses this risk, in some instances the controlled foreign company rules, capital gains tax and the general anti-avoidance provisions may also be relevant.

### **Shipping Hubs**

107. As the majority of oil and gas from Australia's offshore projects will be exported, the shipping function is a key component of the export value chain. Multinational enterprises may operate their shipping functions in different ways. Some may have the shipping function in-house, whilst others will prefer to use third party providers. In some instances taxpayers may establish a hub to centralise their shipping functions on either a regional or global basis.
108. As with functions such as sales, marketing and distribution, shipping functions may also be centralised. Similarly, shipping hubs are also generally located in or relocated to low tax jurisdictions and therefore may pose a profit shifting risk.
109. To date, the ATO has conducted limited assurance activities in relation to shipping hubs. However, due to the expected growth of the oil and gas sector in the near future, we have commenced a review to identify possible systemic risks associated with shipping arrangements. A key focus area is to assure that related party shipping arrangements are not resulting in excessive charges to Australian producers either through a direct fee or a reduction of sales price.
110. To the extent that systemic risks are identified, areas of concern will be flagged with the relevant scoping and public guidance (if necessary) expected by the end of 2017. Assurance activities at an individual taxpayer level will continue throughout this process.

## Procurement Hubs – “non-core” and “core” purchases

111. Similar to the marketing hub issues, some taxpayers that are part of a multinational group are using offshore procurement hubs located in low tax jurisdictions to supply goods and services to Australia. Under a typical offshore procurement hub arrangement, the hub will coordinate procurement for group members and the Australian entity is obliged to source goods and services from the hub.
112. A procurement hub may operate under a buy/sell model, where the hub purchases and on sells goods, or an agency model, where the hub facilitates the delivery of the goods or service but does not take title to the goods. Under the buy/sell model the procurement hub would receive a margin on the goods, whereas under the agency arrangement they receive a service fee.
113. The ATO is reviewing arrangements involving multinational enterprises using procurement hubs to procure core and non-core inputs into their business. Core activities are the essential, defining activities of an organization. An example of this is the downstream operations of an oil and gas company importing crude oil for resale. Non-core inputs are those which generally do not drive an enterprise’s value proposition to its customers (for example, consumables and minor plant and equipment). For example, logistics would constitute a non-core activity for a mining company, but would be a core activity for a transportation company.
114. Significant tax risks can arise where the reward of the offshore entity performing the procurement activities is not in line with its value-added contribution. As an example, if the offshore entity’s sole contribution was to consolidate the multinational’s demand in order to achieve lower prices on third party inputs, this would be considered as the group’s contribution, as opposed to the offshore entity’s contribution alone. As such, those cost savings should be appropriately shared amongst the group, as opposed to being booked solely in the offshore entity. Again, the question is not only the value generated by the hub activities, but also how much of that value the hub would capture if it were a third party.
115. The ATO accepts that businesses will often outsource non-core procurement activities to third parties, but has concerns with regards to the pricing of those activities between related parties of a multinational group. In relation to core procurement activities, the market observations are that these activities are generally not outsourced, which provides challenges for the ATO in determining the appropriate value in a multinational context.
116. As a general proposition, the ATO does not consider procurement to provide the same value to an organisation as sales/marketing activities.

117. The ATO is currently drafting a schedule to be included in the Hubs PCG to provide indicators for non-core procurement activities. A draft schedule will be released for public consultation in the third quarter of this year.

## Related party debt financing issues

### Whether the interest rate paid to the offshore parent is excessive

118. As noted earlier in this submission, the oil and gas sector is a significant capital importer. A significant portion of the foreign capital provided to subsidiaries of foreign multinationals is invested via related party financing arrangements (both loans and associated financial instruments like derivatives). Our data shows for the 2014-2015 income year approximately \$97 billion of related party loans were in place in the oil and gas industry, giving rise to approximately \$3.9 billion of interest paid to related parties offshore<sup>11</sup>. This represented approximately 48% of related party loans in the energy and resources sector (which had related party loans of approximately \$202 billion and interest paid to related parties of \$6.9 billion) and 23% of total related party loans (which was approximately \$420 billion for 2014-2015).<sup>12</sup>
119. Whilst the significant levels of related party loans in part reflect the capital intensive nature of the oil and gas sector, questions remain as to the appropriateness of the costs associated with these debts. Related party financing poses a tax risk, through both transfer pricing as well as more complicated schemes to avoid tax, that the financing costs charged to the Australian entity by the offshore related party are excessive, reducing the taxable income of these entities in Australia.
120. In practice, the key incentive to charge an excessive interest rate on related party debt is that the interest income of the counterparty is not fully taxed on a current basis in the other country. This can be due to the use of a hybrid instrument (debt for Australian purposes, tax preferred equity for foreign purposes), the use of hybrid entities (the interest income will often be disregarded for foreign tax purposes) and/or the use of lenders in low tax jurisdictions (often established in a way that “home country” controlled foreign company rules do not apply to “top up” the low tax).

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<sup>11</sup> The difference between related party interest and the interest expense disclosed in table 4, is largely due to some taxpayers recording interest capitalised for accounting purposes at a different label on the tax return (therefore this is not included in table 4) and others not deducting related party interest at this time (although this interest remains in dispute). Interest expense in table 4 will also include interest paid to third parties.

<sup>12</sup> These amounts exclude interest equivalent amounts paid under cross currency interest rate swaps entered into with related parties, and so are understated.

121. The ATO was successful in challenging the excessive interest charged in the related party borrowing arrangement in *Chevron Australia Holdings Pty Ltd v FC of T* [2015] FCA 1092 (*Chevron*). In *Chevron*, Robertson J, found in favour of the Commissioner that the interest rate paid on a US\$2.5 billion loan related party loan was not arm's length under Australia's former transfer pricing rules. This case resulted in a tax shortfall of approximately \$250million. This matter is currently the subject of a Full Federal Court appeal.
122. Consistent with the decision in *Chevron*, the Commissioner will continue to take issue with arrangements in circumstances where an Australian subsidiary pays rates of interest on related party loans well in excess of what is (or would be) paid on external borrowings by the multinational group, including if the subsidiary had been allowed to obtain debt funding from an unrelated third party.
123. Contrary to this view, some taxpayers are pricing their related party loans having regard to conditions which do not reflect commercially rational behaviour and do not (or would not) exist in their dealings with unrelated third parties, resulting in increased financing costs and associated deductions. This includes entering into types of financial instruments with inherently high interest rates, having regard to only the credit rating of a subsidiary as a standalone entity rather than as a member of a multinational group, and borrowing (either as a loan, or a loan combined with an associated derivative<sup>13</sup>) in an inappropriate currency.
124. The ATO is continuing its assurance activities in relation to this risk in the oil and gas sector and more generally across the taxpayer population. There are a number of audits in relation to taxpayers in the oil and gas sector already on foot in varying stages of progress. We are also continuing to work with these taxpayers to agree on mutually acceptable arrangements to be put in place on a go forward basis. As a starting point, the ATO would generally compare the terms and resultant interest rates on related party borrowings to those of external borrowings raised by the multinational group, and consider whether any differences are commercially rational.
125. The ATO is currently developing a Practical Compliance Guideline to assist taxpayers to assess the compliance risk associated with their related party financing arrangements, in particular their related party loans. Taxpayers will be able to use the guideline to assess the likelihood that the ATO will consider that they are at risk of obtaining a transfer pricing benefit in relation to their related

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<sup>13</sup> In certain cases, the ATO is seeking to deny deductions for payments under the related party derivative as well as challenge the underlying interest rate on the actual loan.

party loans. By applying the guideline taxpayers are able to manage their compliance risks, and therefore their compliance costs associated with their related party finance arrangements. Taxpayers in the low risk zone are able to be confident that the ATO will not view their arrangements as a compliance risk. The ATO anticipates that the draft Guideline will be released this financial year for public consultation.

### **Whether the company is truly within thin capitalisation limits?**

126. The combination of falling commodity prices (leading to a decrease in “on balance sheet” asset values as a result of impairments) and the reduction in the safe harbour limit in the thin capitalisation rules from 75% to 60% has been placing increasing pressure on taxpayers’ thin capitalisation positions. If a taxpayer exceeds the safe harbour limit some of its debt deductions will be denied (unless it satisfies one of the other two thin capitalisation tests). Given the current economic outlook for oil this issue is particularly relevant to subsidiaries of multinational groups in the oil and gas sector that have a significant amount of related party debt.
127. In certain circumstances, taxpayers are able to increase their maximum allowable debt capacity under the thin capitalisation rules (and consequently the amount of debt deductions they may be able to claim) by revaluing their “on-balance sheet” assets and/or recognising and revaluing certain intangible assets only for the purposes of the thin capitalisation calculation.
128. In doing so, taxpayers may rely upon asset recognition and revaluation principles within accounting standards as well as modifications to the application of accounting standards made via the thin capitalisation provisions (modifications that are made only for the purposes of the thin capitalisation calculation). However, strict requirements must be met. These modifications permit some entities to recognise additional value that may not be recognised in the financial statements (e.g. after the introduction of IFRS in 2005, some specific internally generated intangible assets were required to be derecognised for accounting purposes). However, such value may have been considered by a financial institution when assessing borrowing capability.
129. The ATO has observed that in some instances taxpayers are seeking to come within the safe harbour limit by adjusting their asset levels for thin capitalisation purposes by incorrectly recognising assets or increasing the value of assets not in accordance with the strict requirements. This is aimed at allowing taxpayers to claim the full value of their debt deductions and minimise Australian income tax, as well as creating future year capacity for additional debt funding, without

facing the denial of any debt deductions. Whilst some taxpayers are revaluing intangible assets, others are claiming that proved deposits or reserves can be treated as represented in fixed assets rather than intangible assets (i.e. the State or Commonwealth mining right).

130. Also, where there is no applicable accounting standard, company management are required under the accounting standards to develop or adopt an accounting policy to overcome the lack of an applicable accounting standard. This can have the potential of giving company management a great deal of flexibility in determining an accounting policy under the accounting standards that would apply for thin capitalisation purposes only.
131. A particular area of focus is where taxpayers adjust the total value of their assets for thin capitalisation purposes only, with that value not being reflected in the audited financial statements (i.e. the statutory accounts) of the entity. In these circumstances, the safe harbour effectively applies to a notional set of accounts, not the accounting position as reflected in the audited financial statements of the entity.
132. In these cases, as the asset values are generally not reported in the audited financial statements of the entity this removes a systemic safeguard to the over-valuing of assets which would exist if the thin capitalisation calculation applied to the audited financial statements of the entity. For example, we have seen examples where effectively the same cash flows have been used to support the carrying value of assets 'on balance sheet' that are also used to support the notionally revalued asset. Furthermore, given the valuations are for thin capitalisation purposes only, they may not be subject to review by independent auditors or the board of directors.
133. The interest deductions claimed through the recognition or revaluation of assets is substantial and has the ability to significantly impact the corporate tax base. Table 8 provides an indication of the magnitude of revaluations that have been undertaken by a handful of participants in Australia's offshore oil and gas industry.

**Table 8: Indicative impact of asset revaluations for thin cap purposes – 1 January 2013 to 31 December 2015<sup>14</sup>**

Asset revaluation	Additional capacity created	Additional debt deductions allowed as a result of revaluations
\$49.4 billion	\$26.94 billion	\$328 million

<sup>14</sup> These figures are indicative as at 16 May 2017. Some income tax returns and international dealings schedules are yet to be lodged.

134. Table 8 shows a significant increase in debt capacity and additional deductions for the period from 2013 to 2015 (notwithstanding that it reflects only a limited number of participants). The additional debt deductions allowed of \$328 million reflects the interest deductions that would have been disallowed in the relevant year had the revaluations not been undertaken<sup>15</sup>. The total additional debt deductions sheltered by the revaluations, may in fact be much larger than \$328 million when future years are taken into account and if any 'extra' capacity (i.e. capacity not already used to shelter debt) is subsequently utilised.
135. The ATO is in the process of reviewing whether these revaluations are permissible under the current law. In developing our view, the ATO is also consulting with industry, subject matter experts, the Australian Accounting Standards Board and the Australian Securities and Investment Commission regarding the understanding and application of the relevant accounting standards.
136. The ATO alerted the market to its concerns in this area last year by publishing Taxpayer Alert 2016/1; Inappropriate recognition of internally generated intangible assets and revaluation of intangible assets for thin capitalisation purposes.
137. Furthermore, the ATO has also issued Taxpayer Alert 2016/9 to alert the market of its concerns relating to an arrangement where taxpayers have taken the view that their 'debt capital' for the purposes of the thin capitalisation rules does not include the value of a 'debt interest' that has been treated wholly or partly as equity for accounting purposes. The debt interest is treated as debt for tax purposes, giving rise to debt deductions, however when valuing that debt in accordance with accounting standards, the value of any component that is classified as equity under the accounting standards is not included within the total amount of debt capital. The ATO does not agree with this view, which fundamentally seeks to manipulate the 60% safe harbour limitation.
138. This has the effect of reducing what would otherwise have been the taxpayer's 'adjusted average debt' and may consequently reduce the amount of debt deductions disallowed under the thin capitalisation regime, with the potential to remove some debt deductions altogether from being limited under the thin capitalisation regime. The ATO is currently seeking external expert advice on

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<sup>15</sup> Noting that some of these revaluations are likely to be allowed under the thin capitalisation provisions, and so the tax potentially in dispute will not be the entire \$328 million.

the classification and valuation of debt and equity under the accounting standards, and will issue some publically available guidance material once that advice has been received. Compliance activity is ongoing.

### **Financing in a way to avoid withholding tax**

139. The ATO is currently reviewing arrangements, including in the oil and gas industry, where it appears that Australian subsidiaries of multinationals have entered into derivative transactions with related parties as a means to avoid withholding tax. This is distinct from circumstances referred to above where derivatives are a method of increasing financing costs and associated deductions in Australia.
140. The arrangements involving these instruments are often very complex and the underlying (non-tax) funding objectives can often be achieved through far simpler arrangements.
141. Whilst an oversimplification, at its most basic level the arrangements involve circumstances where Australian subsidiaries have borrowed from related parties in a currency which does not make commercial sense in the circumstances of the Australian business. The parties then enter into a currency derivative, such as a cross-currency interest rate swap, purportedly to manage the exchange rate volatility that is said to arise from the denomination of the underlying related party loan. The cross-currency interest rate swap has the effect of swapping the currency of the loan (e.g. USD) with the counterparty to match the dominant currency of the Australian business (e.g. AUD), thereby changing the lower interest rate of the USD loan into a relatively expensive synthetic AUD loan.
142. Under the arrangements interest withholding tax would apply to interest paid to the related party in respect of the USD related party borrowing. Withholding tax would also have applied to interest on any AUD related party borrowing, had the borrowing been denominated in AUD (rather than a USD borrowing and associated swap). The rate of withholding would vary depending on the location of the lender. Interest withholding tax is generally not payable on net payments made by the Australian entity under the swap as the payments are not interest. Both the interest and the net swap costs are prima facie deductible for income tax purposes.
143. The ATO is currently scrutinising a number of these types of arrangements. Our current thinking is that the synthetic replication of an AUD loan in this way may attract the application of the general anti-avoidance provisions if the evidence shows that this was done for the dominant purpose of avoiding



withholding tax. This might be the case, for example, in circumstances where the risks which the derivative is purportedly hedging either do not in fact exist, need not have arisen in the first place, or are already effectively hedged through other means.

144. The Australian entity is also at risk of having obtained a transfer pricing benefit under the transfer pricing provisions equal to the net swap costs.
145. The ATO issued a Taxpayer Alert 2016/3 *Arrangements involving related party foreign currency denominated finance with related party cross currency interest rate swaps* last year, which sets out our concerns in relation to these arrangements.

