TRANSFER PRICING

SUPPLEMENTARY MEMORANDUM OF ADVICE

Introduction

1. In our Advice dated 11 May 2009, and in a subsequent discussion with ATO officers, we observed that an understanding of the potential interaction between Div 13 of Pt III of the *Income Tax Assessment Act* 1936 (**the 1936 Act**), Div 820 of Pt 4-5 of the *Income Tax Assessment Act* 1997 (**the 1997 Act**) and the 'associated enterprises articles' in Australia's double tax treaties may be assisted by considering the operation of a particular factual scenario that could attract the operation of Div 13, Div 820 and/or an associated enterprises article.

2. We have now been asked to provide a further advice as to how these three areas of the taxation law operate in the context of the scenario set out in paras 59 to 63 of the ATO's discussion paper headed "Intra-group finance guarantees and loans - Application of Australia's transfer pricing and thin capitalisation rules". Essentially, the scenario refers to the situation where an international parent of an Australian subsidiary is prepared to assume a higher level of risk in respect of debt than an independent lender would be prepared to take by contributing to the subsidiary only a small amount of equity and a significantly larger amount of debt, for which it would be paid a high interest rate (eg sub-prime or junk bond rates) because the debt was unsecured and the subsidiary had a weak debt:equity ratio.

Scenario

3. The scenario is as follows:

(a) An Australian subsidiary, which is an industrial company, has a balance sheet of $400 million in assets that is funded by its foreign parent with $300 million of debt and $100 million of equity. The debt funding is provided unsecured at an interest rate of 15%, compared with 10% being paid by the parent on the $400 million it borrowed to make the $100 million investment in the subsidiary and also to provide the $300 million loan. The 15% interest rate is based on the junk bond or sub-prime status of the subsidiary, which arises by reason of its weak debt:equity ratio. The interest expense each year is accordingly $45 million for the Australian subsidiary. The capital structure of the Australian subsidiary is within the 3:1 safe harbour debt:equity test in Div 820, but the capital structure leaves the subsidiary in a position where it is not creditworthy on a stand-alone basis.

(b) The following question then arises. If the subsidiary could not borrow $300 million from independent lenders, what is its tolerance to debt funding having regard to its assets of $400 million, its equity of $100 million and its current profitability and cashflow? Market and wider economic and country factors will also be relevant. If it is assumed that, having regard to all the relevant criteria, the subsidiary could borrow $100 million from independent lenders at 12%, that would still leave $200 million needed to fund the balance sheet of $400 million, assuming the cashflow from the subsidiary's business operations was sufficient to meet its working capital requirements and service the debt obligations on the $100 million loan.

(c) As an independent entity dealing with other independent parties in the capital markets, the subsidiary is not able to raise the full amount of the additional $200 million as debt funding. However, it is able to raise a further $90 million from independent parties at 12% interest on the basis that $110 million of equity is raised. The market does not rate the subsidiary as creditworthy for any higher amount given the total borrowings of $100 million and the additional $90 million that need to be serviced from the same underlying cashflow.

(d) It follows in this scenario that the final $110 million of the debt funding that the parent has provided could not have been raised as debt in the open market in dealings between independent parties dealing wholly independently with each other having regard to the economic circumstances of the subsidiary (including its assets, shareholders' funds, earnings and cashflow, and the other risk, market and economic factors taken into account by independent lenders). While the final $110 million is in form part of a loan from the parent it is comparable to equity funding when it is judged by reference to the outcomes it achieves and the behaviour of independent parties in comparable circumstances dealing at arm's length with each other.

(e) On this basis, the annual interest cost is unlikely to have exceeded 12% of $190 million (ie $22.8 million) if the dealings had occurred between independent parties dealing at arm's length with each other. However, the actual interest expense incurred annually was $45 million.

The maximum allowable debt under Div 820

4. Because the subsidiary's debt:equity ratio is within the 3:1 safe harbour debt amount provided for under s 820-195 in Div 820, the debt falls within the maximum allowable debt under s 820-190. Accordingly, in the scenario Div 820 has no work to do.

5. In any event, as we explained in [27] of our Advice, Div 820 operates to reduce the amount otherwise deductible as the arm's length consideration after applying Div 13, by allowing the consideration determined under Div 13 to be deducted only in respect of the maximum allowable debt determined under Div 820, rather than in respect of the higher amount of the actual debt. The primacy of Div 13 over, inter alia, Div 820 (see ss 136AB(1) and 136AD(3)) has the consequence that the arm's length consideration must first be determined under Div 13, and without regard to Div 820. However, if the arm's length consideration for the actual debt is determined under Div 13 on the basis that the actual debt exceeds the maximum allowable debt under Div

820, the amount of the deduction that would be allowed under Div 820 is the arm's length consideration determined under Div 13, but that deduction will only be allowed in respect of the maximum allowable debt, rather than the actual debt.

The arm's length consideration under Div 13

6. The task required by s 136AD(3)(c) is to determine whether the 'consideration in respect of the acquisition' of property 'exceeded the arm's length consideration in respect of the acquisition'. In the scenario, the property that was acquired by the subsidiary is a loan of $300 million (see the definitions of 'acquire', 'property' and 'services' in s 136AA(1)).

7. The relevant definition of 'arm's length consideration' in s 136AA(3)(d) refers to the consideration that would have been given 'in respect of the acquisition if the property had been acquired under an agreement between independent parties dealing at arm's length with each other in relation to the acquisition'. The application of the definition, whether under s 136AD(3) or (4), requires the substitution of a hypothetical transaction for the actual transaction, albeit one that is in respect of the 'property' acquired under the actual transaction (ie an unsecured loan to the subsidiary of $300 million).

(a) If independent parties would have been prepared to lend $300 million to the subsidiary

8. If arm's length parties would have been prepared to lend $300 million to the subsidiary, at the rate charged by the parent of 15% (ie $45 million per annum), it would be open to the Commissioner to be satisfied that the actual consideration was the arm's length consideration in respect of the acquisition. However, if arm's length parties would have been prepared to lend $300 million to the subsidiary at 12% (ie $36 million per annum) the arm's length consideration would be less than the actual consideration and the Commissioner could determine to apply s 136AD(3) so that annual interest at 12%, or $36 million, would apply under the 1936 Act and the 1997 Act to the subsidiary 'for all purposes', including the general deduction provisions in s

8-1 of the 1997 Act (see s 136AD(3). However, neither of those fact situations arise under the scenario.

(b) If independent parties would not have been prepared to lend $300 million to the subsidiary

9. If, as is provided in the scenario, arm's length parties would not have been prepared to lend $300 million to the subsidiary, it will not be possible or practicable to identify the arm's length consideration in respect of the acquisition. Section 136AD(4) specifically provides for that situation by permitting the Commissioner to ascertain an amount which then is deemed to be the arm's length consideration for the purposes of s 136AD(3).

10. Section 136AD(4) enables the Commissioner to ascertain an amount as the arm's length consideration where it is not possible or not practicable for the Commissioner to ascertain what would have been paid as the consideration under an agreement between independent parties dealing at arm's length with each other in relation to the acquisition.

11. In the scenario, arm's length parties would not regard the subsidiary as being sufficiently creditworthy to receive a $300 million unsecured loan. Accordingly, the subsidiary could not borrow $300 million from independent parties. On an arm's length basis the best result the subsidiary can achieve on its present capital structure would be to borrow $100 million from independent lenders at 12%, leaving a balance of $200 million unfunded. However, independent parties would lend a further $90 million at 12% if a further $110 million of equity is injected. Put simply, the creditworthiness of the subsidiary in the market is such that the maximum arm's length borrowing it could achieve would be $190 million at 12% (ie $22.8 million per annum interest), provided there was a further equity contribution of $110 million.

12. Thus, in the scenario the closest the Commissioner could get to ascertaining an arm's length consideration in respect of the subsidiary's borrowings was annual interest of $22.8 million. Anything more would not be an arm's length consideration. The problem is that the ascertainment of $22.8 million is not for 'the acquisition' but,

rather, is the closest the Commissioner could get to an arm's length consideration in respect of the maximum amount that independent parties would lend to the subsidiary. The question is whether the consideration of $22.8 million so ascertained by the Commissioner can be deemed under s 136A(4) to be the arm's length consideration for 'the acquisition', which was a $300 million dollar loan, and not a $190 million loan.

13. The Explanatory Memorandum[1] which introduced Div 13 refers, as an example of when s 136AD(4) might apply, to the situation where there are no comparable dealings in the same quantities as that acquired under an agreement. It states:

> '**Section 136AD : Arm's length consideration deemed to be received or given**
>
> ...
>
> Turning to another aspect of section 136AD, there will be circumstances in which it is not possible or not practicable for the Commissioner to ascertain the arm's length consideration in relation to a particular supply or acquisition of property in accordance with the defined meaning in paragraphs 136AA(3)(c) and (d). Such circumstances might arise where, for example, the industry is so controlled and structured that there are no comparable arm's length dealings in relation to property of the same kind, or there are no comparable dealings in the same quantities as that supplied or acquired under the agreement. They could also arise if, though there are comparable dealings, details of them are held back from or otherwise not available to the Commissioner.
>
> To deal with situations of this kind, sub-section 136AD(4) provides that where, for any reason, including an insufficiency of information available to the Commissioner of Taxation, it is not possible or not practicable for the Commissioner to ascertain the arm's length consideration in respect of a supply or acquisition of property, the arm's length consideration shall be deemed to be such amount as the Commissioner determines.
>
> ...'

1 The Explanatory Memorandum to *Income Tax Assessment Amendment Bill* 1982.

14. In the example, the closest arm's length scenario is a loan of $190 million at 12%, provided a further $100 million of equity is raised. That scenario provides the closest approximation to an arm's length consideration in the facts and circumstances of the case in the situation where, to adopt the language used in the Explanatory Memorandum, 'there are no comparable arm's length dealings in relation to property of the same kind, or there are no comparable dealings in the same quantities as that supplied or acquired under the agreement'. In these circumstances, the Commissioner might ascertain that the amount of interest at 12% on $190 million, or $22.8 million, is the arm's length consideration under s 136AD(4), and thus for the purposes of s 136AD(3). In so doing, again adopting the language used in the Explanatory Memorandum, the Commissioner has ascertained the arm's length consideration that is deemed to be the consideration under s 136AD(4) in circumstances 'where, for any reason, … it is not possible ... to ascertain the arm's length consideration in respect of a supply or acquisition of property'.

15. The view which we take of the operation of s 136AD(4) does not involve a restructuring of the loan. Rather, it involves a recognition that, as it is not possible or practicable to determine an arm's length consideration in respect of the acquisition, it is necessary to identify an amount that is to become the arm's length consideration under s 136AD(4). Our view also does not involve re-writing the section. Rather, it seeks to apply the section to 'the acquisition' in circumstances where there are no comparable dealings or loans being made. Therefore, in ascertaining the arm's length consideration in respect of the acquisition the Commissioner may have three possible choices in respect of a determination by him under s 136AD(4). The first is to ascertain that there is no arm's length consideration in respect of 'the acquisition'. The second is to apply the consideration of 12% for $190 million to 'the acquisition' ie the $300 million loan. The third is to arrive at the closest comparable arm's length consideration that would be expected to be paid by the arm's length taxpayer seeking 'the acquisition', but having to accept the loan the market would be prepared to make at the market interest rate for that loan. The last scenario, rather than the two earlier

scenarios, is consistent with the purpose of s 136AD(4), and better gives effect to the object and intention of the subsection.[2]

16. Put another way, the Commissioner has ascertained an arm's length consideration to be deemed the arm's length consideration for the purposes of s 136AD(3) by relying on the closest approximation to the acquisition, rather that conclude that:

(a) there could not be such an acquisition and therefore there is no arm's length consideration (which understates any arm's length consideration); or

(b) the arm's length consideration is 12% on the $300 million loan (which overstates any arm's length consideration).

The associated enterprises article

17. For the purpose of the scenario we propose to refer to Art 9 of the Swiss treaty, which is Sch 15 of the *International Tax Agreements Act* 1953 (**the Agreements Act**). The article embodies the principle, which with some variations, applies generally in associated enterprises articles in Australia's double tax treaties.

[2] We outlined the relevant principles of construction in this regard, including considering the Explanatory Memorandum, in [70] of our Advice.

18. Article 9 refers to ‘conditions [which] operate between the two enterprises in their commercial or financial relations which differ from those which might be expected to operate between independent enterprises dealing wholly independently with one another’. Any profits which, but for those conditions, might have been expected to accrue, may be included in the profits of the relevant enterprise and taxed accordingly. The application of Art 9 involves eliminating those aspects of the commercial and financial relations which differ from those which might be expected to operate between independent enterprises and by reason of which profits have not accrued. In the context of the scenario (and probably in other contexts) there is no relevant distinction between the criterion in the associated enterprises article (ie independent enterprises dealing wholly independently with each other) and the Div 13 criterion (ie independent parties dealing at arm’s length with each other).

19. The scenario does not specifically identify the conditions which operate between the Australian subsidiary and its foreign parent in their commercial and financial relations which differ from those which might be expected to operate between independent parties dealing wholly independently with one another. However, the scenario provides that, if the subsidiary and its foreign parent had dealt with each other at arm’s length, at best the subsidiary would have been expected to receive a loan of $190 million at an annual interest of 12%, or $22.8 million. This suggests that if those aspects of the commercial and financial relations which differ from those which might be expected to operate between independent enterprises were eliminated, the subsidiary would have been expected to incur annual interest at 12% on a loan (or loans) of $190 million.

20. Article 9 operates in relation to ‘any profits which ... might have been expected to accrue to one of the enterprises, but, by reason of those conditions, have not so accrued’. Any such profits ‘may be included in the profits of that enterprise and taxed accordingly’. A reference to ‘profits’ in Art 9 is to be read as a reference to ‘taxable income’. In that regard, s 3(2) of the Agreements Act provides:

> ‘For the purposes of this Act and the Assessment Act, a reference in an agreement to profits of an activity or business shall, in relation to Australian

> tax, be read, where the context so permits, as a reference to taxable income derived from that activity or business.'

21. Under s 4-15(1) of the 1997 Act, taxable income is calculated as assessable income less deductions. In the scenario, if the subsidiary and its foreign parent had been independent enterprises dealing wholly independently, greater profits (or taxable income) might have been expected to accrue to the subsidiary. That is because a lesser amount, being $22.8 million, would have been expected to be the annual deduction to the subsidiary in respect of interest, not $45 million. The profits (or taxable income) which did not accrue by reason of the relevant conditions is the difference of $22.2 million. Under Art 9, the additional profits (or taxable income) of $22.2 million can be included in the Australian subsidiary's taxable income and taxed accordingly.[3]

22. In the result, unlike Div 13, Art 9 provides for a reconstruction of the relevant transaction by requiring that transaction to be considered by disregarding the commercial or financial relations between the foreign parent and the subsidiary in so far as they differ from those that might be expected to operate between independent enterprises dealing wholly independently with each other.

Conclusion

23. In the scenario, the same end result would be arrived at under s 136AD(3), in conjunction with s 136AD(4), as under Art 9. As the process by which the different provisions operate is not the same a different end result might apply in a different fact situation. Ultimately, although each case will depend on its own facts there is greater scope under Art 9 than there is under Div 13 for the Commissioner to arrive at a result that accords with that which independent parties dealing on an arm's length basis could be expected to arrive at. One reason for that is that Art 9 permits a reconstruction of the relevant transaction to make it accord with the surrogate arm's length transaction. However, Div 13 still requires a determination of the arm's length consideration in respect of the acquisition.

---

[3] We discussed the Commissioner's assessment powers in relation to associated enterprises articles at [42] to [73] of our Advice. See also s 15AA of the *Acts Interpretation Act* 1901.

Dated: 23 June 2009

Ron Merkel

Diana Harding