TR 2010/7 - Income tax: the interaction of Division 820 of the Income Tax Assessment Act 1997 and the transfer pricing provisions

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There is a Compendium for this document: **TR 2010/7EC** .

On 8 April 2024, the *Treasury Law Amendment (Making Multinationals Pay Their Fair Share - Integrity and Transparency) Act 2024* was enacted. The amendments apply to assessments for income years commencing on or after 1 July 2023, with the exception of new integrity rules (debt deduction creation rules) which apply in relation to assessments for income years starting on or after 1 July 2024.

Under the new thin capitalisation rules:

- the newly classified 'general class investors' will be subject to one of 3 new tests
  - fixed ratio test
  - group ratio test
  - third party debt test
- financial entities will continue to be subject to the existing safe harbour test and worldwide gearing test or may choose the new third party debt test
- ADIs will continue to be subject to the previous thin capitalisation rules
- the arm's length debt test has been removed for all taxpayers.

ADIs, securitisation vehicles and certain special purpose entities are excluded from the debt deduction creation rules.

Entities that are Australian plantation forestry entities are excluded from the new rules. For these entities, the previous rules will continue to apply.

This ruling contains references to repealed provisions, some of which may have been re-enacted or remade. The ruling has effect in relation to the re-enacted or remade provisions. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten.

Australia's tax treaties and other agreements except for the Taipei Agreement are set out in the

Australian Treaty Series. The citation for each is in a note to the applicable defined term in sections 3AAA or 3AAB of the International Tax Agreements Act 1953.

Taxation Ruling

Income tax: the interaction of Division 820 of the *Income Tax Assessment Act 1997* and the transfer pricing provisions

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This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

What this Ruling is about

1. This Ruling explains the views of the Australian Taxation Office (ATO) on how the thin capitalisation provisions in Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] interact with the transfer pricing provisions.

2. In doing that, this Ruling necessarily makes some observations on methods to be used to work out an arm's length consideration under the transfer pricing provisions in relation to cross-border debt financing arrangements. However, the focus of this Ruling is the interaction between the thin capitalisation and transfer pricing provisions. Taxation Rulings TR 92/11[2] and TR 97/20[3] continue to provide the Commissioner's views on transfer pricing methods in relation to debt arrangements.

3. A reference in this Ruling to 'transfer pricing provisions' is a reference to Division 13 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936)[4] and the relevant provisions of Australia's tax treaties.[5]

Ruling

4. The transfer pricing provisions are applied before the thin capitalisation provisions in determining the deduction allowable for the pricing of debt.

5. It is clear from the wording of paragraph 820-40(1)(b) that the operation of Division 820 is limited to costs incurred by an entity in relation to a 'debt interest'[6] issued by the entity, that it can otherwise deduct from its assessable income. Accordingly, all provisions relevant to deductibility, including the transfer pricing provisions, must be applied before Division 820 comes into operation.[7]

6. Therefore, the transfer pricing provisions apply firstly to require an arm's length consideration for debt funding that is provided on a non-arm's length basis, with the thin capitalisation provisions

[1] All references in this Ruling to Division 820 and its provisions are references to Division 820 of the ITAA 1997.
[2] Income tax: application of the Division 13 transfer pricing provisions to loan arrangements and credit balances
[3] Income tax: arm's length transfer pricing methodologies for international dealings. Paragraph 4 of TR 97/20 says "[t]he principles contained in this Ruling [that is, TR 97/20] are applicable to *all nature of dealings*, including dealings involving intangibles, intra-group services and cost contribution arrangements" (emphasis added).
[4] All references to Division 13 are references to Division 13 of Part III of the ITAA 1936.
[5] Provisions of Australia's tax treaties, notably the Business Profits Article and the Associated Enterprises Article, contemplate adjustments to profits to reflect the outcome that would be achieved if cross-border dealings had been conducted in accordance with the internationally accepted arm's length principle.
[6] 'Debt interest' is defined in Subdivision 974-B of the ITAA 1997.
[7] See paragraph 1.79 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001.

then operating on the amount of debt deductions[8] determined based on that consideration.

7. The purpose of Division 820 is to set an upper limit, in the case of a non-Authorised Deposit-taking Institution (ADI),[9] on the amount of debt[10] in respect of which an entity can claim tax deductions.[11] Where an entity's level of debt (that is, the 'adjusted average debt') exceeds its statutory upper limit (the 'maximum allowable debt'), Division 820 achieves this outcome by denying a proportion of the otherwise allowable debt deductions of the entity.

8. It follows that Division 820 can operate to effectively reduce the amount of interest, guarantee fees or other associated costs deductible *after* the application of the transfer pricing provisions, to the extent to which these costs are debt deductions and the actual amount of debt of the entity exceeds its 'maximum allowable debt'.

9. Division 820 addresses only the amount of debt an entity can have for purposes of deductibility of its debt deductions, while the transfer pricing provisions alone deal with the pricing of the consideration given for this debt.

10. Accordingly, where an entity does not have 'excess debt',[12] such that the thin capitalisation provisions in Division 820 would not result in the disallowance of any portion of the amounts comprising an entity's 'debt deduction', the transfer pricing provisions can still be applied to adjust the pricing of the consideration given to obtain and maintain the debt funding. Such costs could include interest expenses, discounts on commercial paper, guarantee fees or other costs that are directly incurred in relation to the debt.

11. TR 92/11 and TR 97/20 continue to provide the Commissioner's views on the appropriate methods to work out the arm's length consideration in relation to debt financing that is provided on a non-arm's length basis. Those Rulings generally contemplate the use of traditional methods or profit methods to work out an arm's length consideration. In accordance with those Rulings, the most appropriate method for determining the arm's length consideration for associated enterprise debt is that which in the particular facts and circumstances and on the available data produces the most reliable measure of the consideration that might reasonably be expected between independent parties dealing at arm's length.

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[8] 'Debt deduction' is defined in section 820-40 of Division 820.
[9] ADI – within the meaning of section 995-1 of the ITAA 1997.
[10] Generally this is debt funding that carries a financing cost, for example, interest or the discount payable by the borrower on debt securities.
[11] With regard to ADIs, TR 2005/11 notes at paragraph 34 that in general terms, debt deductions will not be disallowed where the Australian operations have at least the minimum amount of ADI equity capital (equity capital), which under the safe harbour test for ADIs is 4% of the risk-weighted assets of the Australian operations. The safe harbour test operates in a similar manner for both Outward and Inward Investing Entities (ADIs).
[12] 'Excess debt' as used in this Ruling is a reference to debt to the extent it exceeds an entity's 'maximum allowable debt' under Division 820 of the ITAA 1997, as defined in section 995-1 of that Act.

12. The existence of a 'safe harbour debt amount' under Division 820 for the taxpayer is not relevant to the determination of an appropriate method or its application.

Examples

13. The following examples are intended purely to illustrate the respective fields of operation of the transfer pricing provisions and the thin capitalisation rules in Division 820. They are not intended to suggest that a particular method for pricing debt must be applied to the circumstances of a particular case.

Example 1 – thin capitalisation adjustment and no transfer pricing adjustment

14. *Aus Co is an Australian resident subsidiary company of For Co, the parent company that is resident in a country with which Australia has a tax treaty. Being an industrial company and not an ADI, Aus Co is an 'inward investment vehicle (general)' for the purposes of Subdivision 820-C.*

15. *For an income year, Aus Co has:*

- *a 'safe harbour debt amount', determined in accordance with section 820-195, of $375m;*
- *'adjusted average debt', determined in accordance with subsection 820-185(3),*[13] *of $400m, of which $200m is borrowed from For Co and $200m from an independent lender, both on the same terms and conditions and both at an interest rate of 10%; and*
- *equity of $100m.*

16. *Aus Co's only debt deductions are for the interest incurred at a rate of 10% on its $400m debt, meaning that it has $40m of debt deductions for the income year.*

17. *The Commissioner applies the transfer pricing provisions to determine the arm's length consideration for the actual amount of the related party debt. Assume that the loan from the independent lender is sufficiently similar to the loan from For Co and the circumstances in which each amount of debt funding was provided do not present material differences that would affect pricing or Aus Co's ability to obtain $400m in debt funding. A comparable uncontrolled price (CUP) method could be applied in determining the arm's length consideration for the loan from For Co based on an interest rate of 10%, provided this produces an outcome that makes commercial sense for For Co and Aus Co in all of the circumstances.*[14]

18. *On that basis the transfer pricing provisions would not be applied to deny any deduction for the $20m of interest on the $200m*

[13] For the purposes of the example 'adjusted average debt' is the same amount as the average debt.
[14] See paragraph 50 of this Ruling.

loan from For Co, because the actual interest rate on that loan does not exceed 10%.

19. *For the purposes of the thin capitalisation provisions in Division 820, Aus Co has 'excess debt' of $25m because of the operation of the 'safe harbour debt amount' rules applied by the taxpayer.*[15] *Section 820-220 would operate to deny $2.5m of Aus Co's $40m debt deductions.*

Example 2 – transfer pricing adjustment and thin capitalisation adjustment

20. *The facts and circumstances are the same as in Example 1, except that the $200m borrowed from For Co is at an interest rate of 15% instead of 10%. Aus Co's debt deductions for the interest incurred on its $400m debt total $50m for the income year.*

21. *On the basis that, as in Example 1, a 10% interest rate can be used to determine the arm's length consideration for the loan from For Co, the transfer pricing provisions operate to deny $10m (being the difference between an interest rate of 10% and 15% on the $200m loan from For Co) of Aus Co's $50m deductions for interest; leaving a total amount of debt deductions of $40m to be considered for the purposes of Division 820.*

22. *Section 820-220 then operates to deny $2.5m of Aus Co's remaining $40m of debt deductions because, by reference to the statutory safe harbour debt amount applied by the taxpayer, it has excess debt of $25m.*

23. *Total costs disallowed are $12.5m ($10m under the transfer pricing provisions and $2.5m under Division 820) leaving a total amount of debt deductions allowable of $37.5m.*

Example 3 – transfer pricing adjustment and no thin capitalisation adjustment

24. *The facts and circumstances are the same as in Example 1, except that Aus Co has $300m of debt'*[16] *($150m from For Co and $150m from an independent lender) and $100m of equity, producing a 'safe harbour debt amount' of $300m. The interest rate on Aus Co's debt to For Co is 15%, so that, before applying the transfer pricing provisions and Division 820, Aus Co has debt deductions of $37.5m.*

25. *On the basis that, as in Example 1, a 10% interest rate can be used to determine the arm's length consideration for the loan from For Co, the transfer pricing provisions operate to deny $7.5m (being the difference between an interest rate of 10% and 15% on the $150m loan from For Co) of Aus Co's $37.5m deductions for interest.*

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[15] Section 820-195.

[16] For the purposes of the example 'adjusted average debt' is the same amount as the debt.

This reduces debt deductions to be considered for the purposes of Division 820[17] *to $30m.*

26. *Section 820-220 would not operate to deny any of that $30m because Aus Co does not exceed the 'safe harbour debt amount' applied by the taxpayer.*

Example 4 – transfer pricing adjustment and no thin capitalisation adjustment

27. *The facts and circumstances are the same as in Example 3, except that the entire $300m of debt is borrowed from For Co at an interest rate of 15%. Aus Co's debt deductions for the interest incurred on its $300m debt total $45m for the income year.*

28. *Unlike the previous examples, there is no internal comparable.*[18] *Given this, available data as to market reference rates for a borrowing of that size and the credit standing that the capital markets would give Aus Co might be able to be used in determining a market rate of interest for the loan from For Co where Aus Co's credit standing would allow it to borrow $300m from independent lenders. This might in turn be used to determine the arm's length consideration for the loan, provided this price produces an outcome that makes commercial sense for For Co and Aus Co in all of the circumstances.*[19]

29. *The analysis may show that the loan from For Co might not reasonably be expected to exist between independent parties dealing at arm's length, for instance because the relatively high cost of the loan produces an outcome for Aus Co, in terms of the profitability, viability or competitiveness of its business, that does not make commercial sense for it. Assume that in this scenario, after considering all arm's length pricing methods and taking account of all the necessary elements of comparability, it is not possible to ascertain the arm's length consideration in respect of the relevant acquisition, there being no evidence that similar arrangements would have been entered into between unrelated parties.*[20]

30. *Assume also that the information available to the Commissioner in this particular case supports a conclusion that the closest arm's length scenario (at which a loan might reasonably be expected to exist between independent parties dealing at arm's length) is a loan of $250 million at 10%, provided a further $50 million of equity is raised. In accordance with subsection 136AD(4) of the ITAA 1936 and the relevant provisions of any applicable tax treaty, the Commissioner determines the arm's length consideration for the actual debt amount of $300m to be $30m by applying the 10%*

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[17] See section 820-40.

[18] 'Internal comparables' are defined in paragraph 2.11 of TR 97/20 as being comparable dealings in comparable circumstances that have been transacted on an arm's length basis by the taxpayer with independent parties.

[19] Refer to paragraphs 47 to 49 and to paragraphs 2.4-2.5, 2.10-2.12, 2.16-2.17, 2.25-2.27, 3.2-3.3 and 3.27 of TR 97/20 and paragraphs 21-26 of TR 2004/1.

[20] Per paragraph 7(j) of TR 92/11.

interest rate to that actual debt amount. The fact that the 'safe harbour debt amount' is $300 million does not prevent this determination being made.

31. *On this basis, the transfer pricing provisions operate to deny $15m of Aus Co's $45m deductions for interest, leaving a total amount of debt deductions to be considered for the purposes of Division 820 of $30m. Section 820-220 would not operate to deny any of that $30m because Aus Co does not exceed the 'safe harbour debt amount'.*

Date of effect

32. This Ruling applies to years of income commencing both before and after its date of issue. We consider that the approach in this Ruling is consistent with past Rulings and also past conduct of the ATO (see the explanation at paragraphs 75 to 82 of this Ruling). However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
27 October 2010

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the proposed binding public ruling.

Transfer pricing provisions

33. The transfer pricing provisions and the thin capitalisation rules have different functions. The function of the transfer pricing provisions is to ensure Australia can counter 'non-arm's length transfer pricing' or 'international profit shifting' arrangements in order to protect the Australian tax base.[21] They provide a mechanism by which Australia adopts the internationally accepted 'arm's length principle' for taxation purposes as the basis for ensuring that Australia receives its fair share of tax by adjusting profits by reference to the conditions which would have existed between independent parties dealing at arm's length (or wholly independently) with each other under comparable circumstances.

Division 13

34. Section 136AD of Division 13 is concerned with the consideration for a supply or acquisition of property by a taxpayer under an international agreement.[22] Section 136AD empowers the Commissioner, if various conditions are met, to determine that the consideration for the property supplied or acquired is taken to be the arm's length consideration for that supply or acquisition.[23] Such a determination can result in adjustments to increase assessable income or to disallow or reduce an allowable deduction. The arm's length consideration replaces the actual consideration for all purposes of the application of the Act in relation to the taxpayer.

35. This results in not only the underlying consideration in respect of the supply or acquisition of property being adjusted to the arm's length consideration, but also has flow-on consequences for the taxpayer where that consideration is relevant to the operation of other provisions of the Act. Subsection 136AB(1) of Division 13 provides that 'nothing in the provisions of this Act other than this Division shall be taken to limit the operation of this Division'. It follows that Division 820 does not limit the operation of Division 13.

[21] TR 94/14 paragraph 10. The relevant treaty articles also operate to allocate taxing rights between countries.
[22] 'International agreement' is defined in section 136AC of Division 13.
[23] Property includes services for this purpose – see the definition of 'property' in subsection 136AA(1) of the ITAA 1936.

36. Division 13 may be applied to determine the deemed arm's length consideration for a loan acquired by a taxpayer under an 'international agreement'.[24] Where, for example, a foreign parent lends money to an Australian subsidiary, the subsidiary acquires 'property' under an 'international agreement' for the purposes of Division 13. Subsection 136AD(3) of Division 13 is the operative provision in the case of an acquisition of property under an 'international agreement'.

37. Under subsection 136AD(3) of Division 13, the deduction for a cost such as interest expense, discount on commercial paper, a guarantee fee or other costs that are directly incurred in relation to the debt claimed by a resident company on a loan received by it from a non-resident company may be reduced if the cost (that is, the amount of the consideration given) is more than an arm's length amount.[25] The task required by paragraph 136AD(3)(c) of Division 13 is to determine whether the actual consideration given exceeded the amount that might reasonably be expected to have been given or agreed to be given if the loan had been acquired under an agreement between independent parties dealing at arm's length with each other in relation to the acquisition.[26]

38. Where it is not possible or not practicable for any reason to ascertain the arm's length consideration in respect of an acquisition, the Commissioner is empowered under subsection 136AD(4) of Division 13 to determine an amount which is deemed to be the arm's length consideration.

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[24] TR 92/11 discusses the supply and acquisition of property under an 'international agreement' in relation to loans and credit balances.
[25] Refer paragraph 7(b) of TR 92/11.
[26] Paragraph 136AA(3)(d) of Division 13 provides that a reference to the arm's length consideration in respect of the acquisition of property is a reference to the consideration that might reasonably be expected to 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.

Tax treaties

39. Provisions of Australia's tax treaties, notably the Business Profits Article and the Associated Enterprises Article,[27] contemplate adjustments to profits[28] to reflect the outcome that would be achieved if cross-border dealings had been conducted in accordance with the internationally accepted arm's length principle. Australia's tax treaties are included as schedules to the *International Tax Agreements Act 1953* (the Agreements Act). All of Australia's treaties preserve the operation of subsection 136AD(4) of Division 13[29] provided the subsection is applied consistently with the principles in the relevant treaty article. Depending on the facts and circumstances of the case the relevant treaty article may also apply according to its own terms without the assistance of subsection 136AD(4).

40. The Commissioner has long considered that an adjustment applying the arm's length principle to the pricing or profit allocation in respect of a taxpayer's international dealings is authorised on the basis of Australia's transfer pricing provisions in Division 13 and those related treaty provisions.[30] This view had been questioned following the Administrative Appeals Tribunal decision *In Re Roche Products Pty Ltd and the Federal Commissioner of Taxation*.[31]

41. Amendments made at the time of the introduction of Division 13 in 1982[32] appeared to signal an intention on the part of the Parliament that amended assessments could be made to give effect to 'a provision of a double taxation agreement that attributes to a permanent establishment or to an enterprise the profits it might be expected to derive if it were independent and dealing at arm's length' (see subsection 170(9B) of the ITAA 1936 and the definition of 'relevant provision' in subsection 170(14) of the ITAA 1936).

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[27] For example, Articles 7 and 9 of the United Kingdom Convention in Schedule 2 of the *International Tax Agreements Act 1953* (Agreements Act).

[28] Subsection 3(2) of the Agreements Act provides that for the purposes of that Act and the ITAA 1936 a reference to profits of an activity or a 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.

[29] See, for example, Articles 7(4) and 9(2) of the United Kingdom Convention.

[30] Note IT 2311, paragraph 18 of IT 2670, paragraph 62 of TR 92/11, paragraphs 18, 184–186 of TR 94/14, paragraph 35 of TR 95/23, paragraphs 1.10–1.11 of TR 97/20, paragraphs 1, 14-15, 29 of TR 1999/1, paragraphs 2.13–2.14 of TR 2001/11, paragraphs 32-33 of TR 2001/13; TD 2002/20 and paragraph 26 of TR 2007/1.

[31] [2008] AATA 639; 2008 ATC 10-036; (2008) 70 ATR 703 – see in particular paragraphs 189 to 191 of the decision. Other cases have touched on the general issue of the status of the treaties, though none dealt with transfer pricing issues: see *McDermott Industries (Aust) Pty Ltd v. Commissioner of Taxation* (2005) 142 FCR 134 at [2]; *Commissioner of Taxation v. Lamesa Holdings BV* (1997) 77 FCR 597 at 600-1; *Chong v. Commissioner of Taxation* (2000) 101 FCR 134 (Chong) at [26]; *GE Capital Finance Pty Ltd v. Federal Commissioner of Taxation* (2007) 159 FCR 473 at [36], [37] and *Undershaft (No 1) Limited v. Commissioner of Taxation* [2009] FCA 41 (Undershaft) at [45], [46].

[32] See subsections 170(9B) and 170(9C) of the ITAA 1936 and the now replaced subsections 225(2) and 226(2B) to 226(2F) of the ITAA 1936.

42. The proposition that there is a power to assess in reliance on the Associated Enterprises Articles in Australia's treaties received favourable comment, in *obiter*, from the Federal Court (Middleton J) in *SNF (Australia) Pty Ltd v Commissioner of Taxation*.[33]

Working out arm's length consideration under the transfer pricing provisions in relation to debt funding

43. The Commissioner has provided extensive guidance on how to work out an arm's length consideration under the transfer pricing provisions.[34] Those provisions incorporate the internationally accepted arm's length principle to determine the arm's length consideration.

General considerations

44. TR 92/11 and TR 97/20 are directly relevant to the pricing of associated enterprise debt and continue to provide the Commissioner's views on the appropriate methods to work out the arm's length consideration in relation to an amount of debt. Those Rulings generally contemplate the use of traditional methods or profit methods to work out an arm's length consideration.[35]

45. In accordance with those Rulings, the most appropriate method for determining the arm's length consideration for an associated enterprise loan is that which in the particular facts and circumstances and on the available data produces the most reliable measure of the consideration that might reasonably be expected between independent parties dealing at arm's length. In any particular case, a traditional method, a profit method or (less commonly) some other approach may be appropriate depending on the facts and circumstances of the case.[36]

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[33] [2010] FCA 635 – see in particular paragraph 23 of the judgment.

[34] See in particular TR 92/11, TR 94/14, TR 97/20, TR 98/11 and TR 1999/1 which together form a complementary suite of Rulings on the application of the transfer pricing provisions.

[35] The traditional methods are the comparable uncontrolled price, resale price and cost plus methods. The profit methods include the profit split and transactional net margin methods. However, as noted at paragraph 1.8 of TR 97/20, the statutory objective of the transfer pricing provisions "should be interpreted as allowing the greatest possible scope to use methodologies appropriate in the circumstances, given the myriad of different and possibly unique cases that may arise".

[36] See, in particular, paragraph 80(a) of TR 92/11 and paragraphs 1.8 and 3.5-3.9 of TR 97/20.

46. In practice, the most reliable method is that which uses available data as to the pricing of a comparable loan between comparable independent parties dealing at arm's length in comparable circumstances. That is consistent with TR 92/11 which said that the 'comparable uncontrolled pricing method will usually be the preferred method for determining the arm's length consideration' and that all the relevant facts and circumstances surrounding the 'international agreement' will be taken into account in determining that consideration.[37]

47. In the absence of such direct comparables data, publicly available data as to market interest rates applicable to rated borrowers can be used in producing a reliable measure of the arm's length consideration, provided the rate used takes account of all relevant facts and circumstances, including whether the borrower has the ability to raise that amount of debt funding from an unrelated third party.[38] TR 92/11 contemplates the use of an appropriate market reference rate (for example, London Inter Bank Offered Rate (LIBOR),[39] Singapore Inter Bank Offered Rate (SIBOR), or the Bank Bill Swap Rate (BBSW))[40] plus an appropriate margin (if any) reflecting the borrower's credit standing as a means of estimating an arm's length interest rate for an associated enterprise loan.[41]

48. However, an approach under which a market interest rate is selected and applied on the basis of a taxpayer borrower's credit rating does not, of itself, ensure a reliable determination of the arm's length consideration for the taxpayer's associated enterprise loans.[42]

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[37] Paragraphs 80(a), 80(b), 83 and 84 of TR 92/11.

[38] See paragraphs 60(g) and 83 of TR 92/11 and paragraph 5.11 of TR 98/11. A similar approach is adopted in paragraphs 28-30 of TR 2002/2.

[39] Subparagraph 80(c) of TR 92/11 states that internationally recognised benchmark rates, such as the LIBOR in the case of Eurocurrency loans and the SIBOR in the case of Asian currency loan facilities, will be taken as generally indicative of the basic interest rates for transactions in those currencies.

[40] The BBSW is a benchmark for the cost of banks funds and is the Australian equivalent of LIBOR and SIBOR. It is the rate at which banks lend to each other (and a reference rate for most floating rate securities). Base bank lending rates, such as BBSW, LIBOR and SIBOR represent the time value of money lent and incorporate a credit risk premium over a risk free rate (such as the Commonwealth Government bond rate). The credit margin above BBSW, LIBOR or SIBOR represents compensation to the bank lender, above its cost of funds, for extending credit to the borrower.

[41] See paragraphs 80 and 85-86 of TR 92/11.

[42] Whilst a borrower's creditworthiness is relevant to determining the price at which it *could* borrow; it does not determine whether the taxpayer as an independent party *would* borrow (or an independent lender would lend) at that price. In addition, the credit rating adopted by the taxpayer should be objectively determined.

49. Another approach may be to derive an arm's length consideration (for example, an interest rate) by reference to the credit rating of the parent of the taxpayer's corporate group, provided that the terms, conditions and other relevant circumstances of the debt in question reflect those that would be found in an arrangement between parties dealing at arm's length.[43] Depending on the facts, including the credit standing of the borrower company relative to the parent company, a margin above the interest rate that the parent would be expected to pay for the debt may be appropriate. Where, for example, the operations of the borrower are core to the group in the sense that its functions were a vital part of an integrated business, it would generally be expected that the borrower company would have the same credit standing as its parent.

50. In using any data as to uncontrolled comparables or open market prices[44] in determining the arm's length consideration for an associated enterprise loan, it is necessary to take account of whether the outcome makes commercial sense in all of the circumstances of the case.[45] This enables a conclusion to be made as to whether independent parties dealing at arm's length would be prepared to lend and to borrow in comparable circumstances and, if so, whether they would agree to a loan at that price.

Relevance of a taxpayer's debt and capital structure

51. Within the framework discussed at paragraphs 45 to 50 of this Ruling, sometimes it may be necessary and appropriate, in the facts of a particular case, for the Commissioner to consider the debt and capital structure of a taxpayer for the purposes of applying the transfer pricing provisions.

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[43] As discussed at paragraph 52 of this Ruling, TR 92/11 notes that the credit standing of the borrower is a relevant fact and circumstance in working out an arm's length consideration in loan arrangements. Taking account of parental affiliation is consistent with the arm's length principle embodied in the transfer pricing provisions where, in determining the creditworthiness of a borrower, it is a feature of the market to take account of any affiliation the borrower has.

[44] TR 97/20 at paragraphs 2.25-2.27, which specifically refers to money market indices, emphasises that it may not always be appropriate to rely on a market index in the particular circumstances of an enterprise. The use of data from market indices should have regard to the need for the analysis to produce outcomes that make commercial sense.

[45] TR 97/20 paragraphs 2.15-2.17, 3.27 and 3.51 and TR 2004/1 paragraphs 21-26.

52. That is consistent with TR 92/11 which, at paragraph 83(g), says that the credit standing of a borrower is a relevant fact and circumstance to be taken into account in determining the arm's length consideration in relation to a loan. There are long established models for determining credit standing which have common characteristics based on a mix of qualitative and quantitative factors. These factors include the capital structure of the borrower (which affects its tolerance for debt funding), asset levels, realisable value of assets, strength of cash flow, capacity to absorb losses, probability of default and extent of recourse (including the possibility of wider recourse, additional financial support and parental affiliation).

53. One of the circumstances where it may be necessary and appropriate for the Commissioner to consider the debt and capital structure of a taxpayer is where the taxpayer has a low net profit position (usually over an extended period) that does not reflect the functions, assets and risks of the relevant business activities and that profit position is attributable to high levels of debt carried by the taxpayer. That causal link might be relevant to the question of whether a profit based method would be the most reliable method that can be employed to achieve a commercially realistic arm's length profit outcome.

54. Another circumstance is where the Commissioner considers that, in accordance with TR 92/11 and TR 97/20, no arm's length pricing method can be applied because, for example, the financing arrangements in question do not reflect commercial and market realities and might not reasonably be expected to exist between independent parties dealing at arm's length.[46] Such a case may be one where it is either not possible or not practicable for an arm's length consideration to be determined.[47] In those cases, it is necessary for the Commissioner to determine the arm's length consideration by having regard to all the facts and circumstances of the case.

[46] This approach is consistent with TR 97/20 and TR 92/11. The latter explicitly ruled that "[w]here similar arrangements would not be entered between unrelated parties, the Commissioner will determine an arm's length consideration on the available information" (see paragraph 7(j) of that Ruling).

[47] See subsection 136AD(4) of the ITAA 1936, the Business Profits and Associated Enterprises Articles of Australia's tax treaties and paragraph 39 of this Ruling.

55. One possible approach in this circumstance, though not necessarily the only approach, is to price an amount of debt by having regard to the amount of debt that the taxpayer would reasonably be expected to have if it was dealing at arm's length with other parties.[48] This might be necessary, for example, to work out the appropriate interest rate to be applied to the actual debt of the taxpayer as a means of determining an arm's length consideration for the transactions actually entered into by the taxpayer.[49]

56. As discussed above, other approaches to work out an arm's length consideration for associated enterprise debt in a case of the kind described in paragraph 54 of this Ruling might be appropriate. It must be emphasised that the appropriate approach in a case of this type will depend on all its relevant facts and circumstances.

57. One of those alternative approaches could be to use the approach discussed at paragraph 49 of this Ruling (deriving an arm's length consideration from the parent's credit rating). A further approach might be to consider the circumstances of comparable companies which operated in the particular market which, under their capital structures and/or with the benefit of parental affiliation, were able to borrow from third parties the amounts in question. The assumption would be that if the taxpayer had been established with a capital structure which would have enabled it to operate on a comparable stand alone basis, it would have achieved a certain credit rating that would allow an arm's length consideration to be determined by reference to market data for comparable transactions, provided adjustments can be reliably made for any material differences.

58. So as not to defeat the operation of Division 820, any arm's length rate of interest derived under any of the approaches discussed at paragraphs 54 to 57 of this Ruling should be applied to the actual amount of debt.

Does this Ruling require a taxpayer to work out an arm's length debt amount in order to comply with the transfer pricing provisions?

59. It is very important to note that this Ruling does not require a taxpayer to work out an arm's length amount of debt to demonstrate that the pricing of their debt is consistent with the transfer pricing provisions. Nor does this Ruling mandate any particular approach to the pricing of that debt.

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[48] Contrast this with the 'arm's length debt amount' test in section 820-215. An arm's length amount of debt determined under arm's length principles might not be the same as the 'arm's length debt amount' determined under section 820-215.

[49] This approach could also be applicable to discounts on commercial paper, guarantee fees or other associated costs.

60. Consistent with the Commissioner's views set out in TR 97/20, and as explained above, the arm's length principle requires that the pricing of a taxpayer's associated enterprise dealings should make commercial sense in all of the circumstances of the case (including the taxpayer's gearing and financial position, cost structure, business strategies and prevailing market and economic conditions).[50] For example, it may not make commercial sense in all the circumstances if financing expenses from an associated enterprise loan were so significant that operating with these costs was not commercially viable or did not leave a commercially realistic return for the functions performed, assets used and risks assumed in the relevant business activities.[51] It is only in those circumstances (which would include cases where the borrower is unable to obtain the required debt funding from independent parties) that the considerations in paragraphs 51 to 58 may become relevant.

61. It follows that this Ruling does not require taxpayers to work out an arm's length amount of debt in order to comply with the transfer pricing provisions. Rather, it is necessary only to show that the taxpayer's associated enterprise debt arrangements reflect a commercially realistic outcome.

Thin capitalisation provisions in Division 820

62. Division 820 is a comprehensive regime whose objective is to ensure that a multinational entity does not allocate an excessive amount of debt to its Australian operations.[52] Paragraph 1.76 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001 (the EM) states that:

> The thin capitalisation rules collectively make up a comprehensive regime. They are specifically directed at debt deductions which, broadly, relate to interest and other costs of borrowing. These features of the regime show that it is intended to cover the whole subject matter to which the thin capitalisation rules apply.

[50] See TR 97/20 paragraph 2.15.
[51] TR 97/20 paragraph 3.27.
[52] Paragraph 1.2 of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 4) 2002.

63. Division 820 operates when the amount of debt used to finance the Australian operations exceeds specified limits that determine the maximum level of debt funding of an entity for income tax purposes.[53] It achieves that outcome by denying otherwise allowable debt deductions for an entity in the same proportion to the extent that the entity has excess debt. Excess debt is defined to mean the amount by which the 'adjusted average debt' exceeds the entity's 'maximum allowable debt'.[54] The 'maximum allowable debt' is the greater of certain safe harbour amounts or the amount worked out under a modified arm's length amount test.[55] The statutory safe harbour amount can exceed the arm's length debt amount.[56]

64. Paragraph 820-40(1)(b) provides that, in order for an amount to form part of a debt deduction of an entity, the amount must be a cost incurred by the entity which, apart from Division 820, would be otherwise deductible for that year of income. This principle is repeated at paragraphs 1.58, 1.79, 1.99, 2.98 (Example 2.10) and 3.14 of the EM.

65. Hence, Division 820 is applied to determine the level of debt funding which is permitted – and to disallow the deductions (interest and other costs of borrowing) that an entity may claim apart from Division 820 (for example under section 8-1 of the ITAA 1997 after applying Division 13) – to the extent that the actual level of debt funding exceeds the maximum level permitted under the options in Division 820. It follows that Division 820 can operate to reduce the amount otherwise deductible as the arm's length consideration after the application of Division 13 if, and to the extent that, the actual amount of debt exceeds the 'maximum allowable debt'.

Relationship between transfer pricing provisions and thin capitalisation provisions in Division 820

66. The EM specifically considered the inter-relationship between the thin capitalisation rules and the transfer pricing provisions. Paragraphs 1.74 and 1.75 of the EM note that:

> 1.74 Some cases will attract the operation of the thin capitalisation rules and the transfer pricing rules in Division 13 of Part III of the ITAA 1936 and comparable provisions of DTAs.
>
> 1.75 A consideration of the scope and purpose of each set of provisions is relevant in determining which provisions are more appropriate to apply in the circumstances of an individual case.

[53] Paragraph 1.2 of the EM.
[54] For an outward non-ADI the excess debt is defined in section 820-115 and for an inward non-ADI the excess debt is defined in section 820-220.
[55] For certain entities there is also a worldwide gearing test.
[56] For example, refer to section 820-90 for non-ADIs.

67. Paragraphs 1.78 and 1.79 of the EM add that:

> 1.78 ... the thin capitalisation rules do not have the same scope as Division 13 and comparable provisions of DTAs – the latter apply to a wider range of transactions. Further, there may be instances where the purpose of the application of the arm's length principle under Division 13 and comparable provisions of DTAs to a particular case is not the same as for applying the arm's length test under the thin capitalisation rules. In these cases, the arm's length principle articulated in Division 13 and comparable provisions of DTAs should apply. For example, the application of the arm's length principle to determine whether a rate of interest is greater than an arm's length amount can only be done under Division 13 and comparable provisions of DTAs.
>
> 1.79 ... In normal circumstances, the amount otherwise allowable is that determined under section 8-1 of the ITAA 1997. However, Division 13 and comparable provisions of the DTAs may also impact on the amount otherwise allowable. The thin capitalisation rules apply, therefore, to the amount of a debt deduction which is otherwise allowable having regard to any other provision in the income tax law or in the DTAs.

68. Accordingly, the adjustment of the cost of debt funding to bring it into line with the arm's length principle is consistent with the wording of paragraph 820-40(1)(b) and the policy of that paragraph as articulated in the EM. It follows that an amount otherwise allowable means costs which satisfy all the relevant deductibility provisions of the Act, including the transfer pricing provisions.

69. This interaction is discussed in Taxation Ruling TR 2003/1.[57] The Ruling states that the transfer pricing provisions are left to operate on questions of profit allocation and rates of dealing.[58]

70. TR 2003/1 further states that the transfer pricing provisions in Division 13 can operate to adjust profits where loans are not on arm's length terms (an excessive interest rate, for example). It also says that in these cases, the arm's length terms and conditions established under Division 13 will be used when conducting the arm's length debt analysis under the thin capitalisation regime. However, the Ruling does not intend that this extends to using Division 13 arm's length capitalisation in Division 820 in the case of entities.[59]

71. The transfer pricing provisions in Division 13 cannot apply to defeat the operation of Division 820 in determining whether an entity's debt levels are excessive for the purpose of disallowing deductions on that 'excess debt'.[60] The Act, read in context, requires Division 820 to operate to achieve its purpose.

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[57] Income tax: thin capitalisation – applying the arm's length debt test.
[58] TR 2003/1, at paragraphs 91 to 93. See also paragraphs 7 and 8 of TR 2003/1.
[59] Note that for non-bank permanent establishments, the attribution of equity and debt is based on the arm's length principle – see TR 2001/11.
[60] On the basis of the Commissioner's views about acceptable arm's length transfer pricing methods for international dealings (see TR 97/20), the practical application of the transfer pricing provisions in the tax treaties is not seen as leading to any different outcome.

72. Except to that extent, Division 820 does not apply to defeat the operation of the transfer pricing provisions in Division 13. An entity cannot circumvent the purpose of the limitation of debt funding in Division 820 by paying above arm's length prices on the lower debt amount. If related entities establish costs above what would be the arm's length cost for the debt funding, the transfer pricing provisions in Division 13 operate in their normal way to allow the costs to be adjusted to the arm's length amount, without causing any conflict with the terms of, and the policy underlying, Division 820.

Provisions relevant to deductibility

73. The operation of Australia's thin capitalisation rules and transfer pricing rules is limited to borrowing costs that the entity can deduct from its assessable income. The deductibility of costs such as interest payments would normally fall for consideration initially under section 8-1 of the ITAA 1997.

74. Such deductions may also be open to challenge under Part IVA of the ITAA 1936. Part IVA of the ITAA 1936 will apply to a scheme which enables a taxpayer to obtain a tax deduction only if it would be concluded that the deduction would not be available but for the scheme and that the dominant purpose of a participant in the scheme was to enable the taxpayer to obtain the deduction, having regard to the criteria specified in section 177D of the ITAA 1936.

Date of effect

75. In response to the draft of this Ruling (draft Taxation Ruling TR 2009/D6) being released, the Commissioner received representations that the date of effect of this Ruling should be prospective only. After very carefully considering those representations, the Commissioner has taken the view that this Ruling should apply before and after its date of issue.

76. As we understand it, the principal concern driving the request for a prospective application date was the perception that draft Taxation Ruling TR 2009/D6 (and an earlier iteration in draft Taxation Determination TD 2007/D20) required a taxpayer to work out an arm's length amount of debt, without regard to the 'safe harbour debt amount' under Division 820, in order to determine an arm's length consideration in relation to the debt.

77. However, this Ruling does not require that.[61] The purpose of this Ruling is to explain the Commissioner's view of how the thin capitalisation rules in Division 820 interact with the transfer pricing provisions. Prior to the issue of TD 2007/D20, the Commissioner had not expressed a detailed view on that issue,[62] nor have we been able to find any evidence that the ATO accepted or contributed to a view contrary to that set out in this Ruling. We do not consider, therefore, that the ATO has facilitated or contributed to any taxpayer taking a view that is contrary to that expressed in this Ruling. In reaching that conclusion, we have examined our written publications and our practices in risk reviews, audits and advance pricing arrangements going back to before 2001.

78. The relevance of a taxpayer's debt and capital structure to the application of the transfer pricing provisions is a matter that bears directly on the interaction of Division 820 and the transfer pricing provisions. We had become concerned that some foreign parent companies had funded their Australian subsidiary with a relatively low amount of equity and high amount of debt, and therefore had assumed a higher level of credit risk in respect of that debt than an independent lender might be expected to assume. The parent then demanded a high interest rate, guarantee fee or other credit support charges because the debt was unsecured and the subsidiary had a weak debt: equity ratio and a consequent low standalone credit rating.[63] This was a new development in the tax system that, it would appear, evolved after the commencement of Division 820.

79. To the extent we have made observations on acceptable transfer pricing methods for the pricing of associated enterprise debt, we have sought to do so only to address arguments put to us, in the context of these cases, that Division 820 significantly restricted the methods in a way which we consider inconsistent with the stated intent of Division 820.[64] We have made the observations within the framework previously laid out by the Commissioner in TR 92/11 and TR 97/20 and have sought to explain how our comments are consistent with the views set forth in those Rulings.

80. In relation to the issue discussed at paragraph 51, our examination of our past practices indicates that at least since the 1990s consideration of the debt and capital structure has consistently been a consideration in achieving an arm's length outcome in relation to risk reviews, audits and advance pricing arrangements. In some cases this has been as direct as asking the taxpayer to address the high level of debt by injecting equity, and in other cases indirectly, by ensuring the method employed achieved a commercially realistic arm's length profit outcome.

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[61] See paragraphs 51 to 61 of this Ruling.
[62] TR 2003/1 made some comments on this issue that are consistent with the views in this Ruling – see paragraphs 69 and 70 of this Ruling.
[63] This is notwithstanding that decisions impacting upon the subsidiary's credit rating were taken by the parent.
[64] See paragraphs 66 to 68 of this Ruling.

81. Specifically, we consider that the use of the approach discussed at paragraph 55 as a last resort is consistent with TR 92/11 and TR 97/20 for the reasons explained in this Ruling. In relation to cases where an arm's length consideration cannot be ascertained using the generally accepted transfer pricing methods, it is not possible for the Commissioner, given the dynamic nature of commerce, to forecast all of the arrangements that may arise in the future and, therefore, set out in precise detail the approach he may need to take in relation to every such arrangement. It is for that reason that TR 97/20 sets out in significant detail the underpinning principles of the transfer pricing methods and notes that the statutory objective of the transfer pricing provisions 'should be interpreted as allowing the greatest possible scope to use methodologies appropriate in the circumstances, given the myriad of different and possibly unique cases that may arise'.[65] It is also why TR 92/11 states that the Commissioner will determine an arm's length consideration on the available information where similar arrangements would not be entered into between unrelated parties.[66]

82. The private ruling system has, since 1992, provided a mechanism for taxpayers to seek the Commissioner's view of how the law applies to specific arrangements that is binding on the Commissioner. In addition, the Commissioner has, for many years, provided a system of advance pricing arrangements (see Taxation Ruling TR 95/23).[67]

[65] See paragraph 1.8 of TR 97/20.
[66] See paragraph 7(j) of TR 92/11. Also see paragraph 2 of TR 92/11.
[67] An advance pricing arrangement represents an arrangement between a taxpayer and a tax authority that establishes the transfer pricing methodology to be used in any future apportionment or allocation of income, deductions, credits or allowances so as to ensure arm's length transfer prices or results are achieved for income tax purposes.

Appendix 2 – Detailed contents list

83. The following is a detailed contents list for this Ruling:

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References

Previous draft:

TR 2009/D6

Related Rulings/Determinations:

IT 2311; IT 2670; TR 92/11;
TR 94/14; TR 95/23; TR 97/20;
TR 98/11; TR 1999/1;
TR 2001/11; TR 2001/13;
TR 2002/2; TR 2003/1;
TR 2004/1; TR 2005/11;
TR 2006/10; TR 2007/1;
TD 2002/20; TD 2007/D20

Subject references:

- arm's length capital amount
- arm's length principles
- arm's length transactions
- capitalisation
- debt deductions
- excess debt
- tax treaties
- thin capitalisation
- thin capitalisation arm's length transaction
- transfer pricing

Legislative references:

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- SNF Australia Pty Ltd v Commissioner of Taxation [2010] FCA 635; 2010 ATC 20-190
- Undershaft (No 1) Limitedd v. Commissioner of Taxation (2009) 175 FCR 150; [2009] FCA 41; 2009 ATC 20-091; 74 ATR 888

Other references:

- Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001
- Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 4) 2002

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NO:	1-1WFDZOX
ISSN:	1039-0731
ATOlaw topic:	Income Tax ~~ Entity specific matters ~~ transfer pricing Income Tax ~~ Tax integrity measures ~~ thin capitalisation