TR 92/11 - Income tax: application of the Division 13 transfer pricing provisions to loan arrangements and credit balances

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Australian Taxation Office

Taxation Ruling

Income tax: application of the Division 13 transfer pricing provisions to loan arrangements and credit balances

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IT2311

*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**, is a public ruling for the purposes of that Part . Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

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What this Ruling is about

1. This Ruling explains:

   (a) the circumstances in which Division 13 of the *Income Tax Assessment Act 1936* (ITAA) may be applied to impute interest income or to deny deductions for excessive interest expense in relation to loans (Part A);

   (b) the treatment of credit facilities or intercompany credit balances for which the resident company is not adequately compensated (Part B);

   (c) the issues to be taken into account in determining whether any agreement that is in legal form a loan may be treated as equivalent to a contribution to equity (Part C);

   (d) the circumstances in which adjustments may be made under the associated enterprises articles of the double tax agreements, being schedules to the *Income Tax (International Agreements) Act 1953,* to impute interest income or to deny deductions for excessive interest payments (Part D);

   (e) the manner in which arm's length interest will be calculated to determine whether a particular transaction is at arm's length and to attribute an arm's length consideration (Part E); and

   (f) the exercise of the Commissioner's discretion in applying the provisions of Division 13 (Part F).

2. The Ruling provides guidelines to be applied to the cases discussed and should not be read as a comprehensive document covering all aspects of the application of Division 13 to loans, credit facilities and intercompany credit balances. In providing these guidelines, there is no intention of laying down any conditions to

restrict officers in the exercise of any discretion. Each case must be decided on its merits.

3. The Ruling is stated in relation to companies. The same principles will apply in relation to other entities such as individuals and trusts.

4. The Ruling does not deal with the special issues arising from the interaction between Division 13 and the calculation of the income of controlled foreign companies and certain non-resident trusts under the accruals tax measures introduced with effect from the 1990-91 income year. Some of these issues are dealt with in Taxation Determination TD 92/103.

5. The Ruling does not also deal with financial arrangements within one legal entity (such as between the head office and a branch of the same company), nor does it deal with adjustments to take into account the secondary effects resulting from adjustments to profits.

Date of effect

6. This Ruling is not concerned with a change in interpretation. Consequently, it applies (subject to any limitations imposed by statute) for years of income commencing both before and after the date on which it is issued.

Part A: the circumstances in which Division 13 may be applied to impute interest income or to deny deductions for excessive interest expense in relation to loans

Ruling

7. (a) Division 13 may be applied to attribute income to a resident company on a loan made by it to a non-resident company if there is no interest income or the interest income on that loan is less than the amount that would have been received by an independent party dealing at arm's length with the borrower.

(b) Division 13 may be applied to reduce a deduction for interest expense claimed by a resident company on a loan received by it from a non-resident company if the interest expense on that loan is more than an arm's length amount.

(c) The fact that interest is not charged would not prevent a transaction being characterised as a loan.

(d) The expression 'supply of property' has a very wide meaning in the context of Division 13 and includes a benefit conferred by one company on another.

(e) A profit shifting or tax saving purpose is not a precondition for the application of Division 13 to a particular transaction. Division 13 can be applied where an international transaction is not on arm's length terms and the effect is that Australian revenue is denied its appropriate share of tax because of the non-arm's length nature of the transaction.

(f) Income is shifted from Australia under an international agreement if:

(i) income that would be expected to be derived in Australia had the dealings under the agreement been at arm's length is shifted offshore;

(ii) income that would be expected to be derived by a resident if the dealings under the agreement had been at arm's length is not derived; or

(iii) deductions are claimed that would reduce the assessable income of a resident by more than the amount that could have been claimed had the dealings under the agreement been at arm's length.

(g) The mere fact that two parties to an agreement are associated will not be determinative in concluding that they were not dealing at arm's length. In the case of a loan, what an arm's length supplier of funds might seek if approached to supply funds under the circumstances will be considered.

(h) The Commissioner does not accept that an increase in the value of the shares held in a subsidiary or the receipt of dividends or the possible receipt of future dividends constitutes arm's length consideration to a parent company for an interest free loan to a subsidiary.

(i) The mere fact that certain interest free financial arrangements are common between members of multinational enterprises does not make the arrangement arm's length.

(j) Where similar arrangements would not be entered into between unrelated parties, the Commissioner will determine an arm's length consideration on the available information.

(k) The existence of a business purpose for a transaction is not in itself sufficient to preclude the making of an adjustment under Division 13.

(l) The fact that interest, if paid, would have been exempt from income tax under paragraph 23(q) would not of itself be sufficient to preclude an adjustment under Division 13.

Explanations

Four conditions to be satisfied before a Division 13 adjustment can be made

8. Four conditions must be satisfied for an adjustment to be made under Division 13 in relation to interest income on a loan made by a resident company to a non-resident company. (subsections 136AD(1) and (2))

9. These conditions are that:

(a) property must be supplied under an international agreement;

(b) the Commissioner must be satisfied that the parties to the international agreement were not dealing at arm's length in relation to the supply of property;

(c) there must be no consideration for the supply of the property under the agreement or the consideration must be less than an arm's length consideration; and

(d) the Commissioner must determine that the provisions of Division 13 should be applied to impute income.

10. Correspondingly, in relation to a loan received by a resident company from a non-resident company, an adjustment may be made under Division 13 if:

(a) there is an acquisition of property under an international agreement;

(b) the Commissioner is satisfied that the parties to the agreement were not dealing at arm's length in relation to the acquisition of property;

(c) the consideration given or agreed to be given exceeds an arm's length consideration; and

(d) the Commissioner determines that the provisions of Division 13 should be applied to deny a deduction. (subsection 136AD(3))

11. The provisions also apply where:

(a) the permanent establishment in Australia of a non-resident company grants a loan to another non-resident company; or

(b) the permanent establishment in another country of a resident company receives a loan from another resident company.

The meaning of the term 'loan'

12. The essential character of a loan is the lender's entitlement to repayment, at some time in the future, of the property lent. The fact that interest is not payable in respect of a supply of funds would not, of itself, lead to the conclusion that the funds are not supplied under a loan agreement.

The meaning of the term 'agreement'

13. The term 'agreement' is given a very wide meaning. The expression is sufficiently wide, for example, to include an implied understanding whereby balances due from one company to another are left uncollected by the creditor company over a substantial period of time. (Section 136AA(1))

Provision of property under an 'international agreement'

14. Property is treated as provided under an international agreement in relation to a loan if property is provided, for example, by a resident company to a non-resident company for use in an offshore business. The provision of property by a non-resident company to a resident company under a loan agreement will also constitute a supply of property under an international agreement. (section 136AC)

15. The property may be supplied between related parties such as a parent company and a subsidiary or between unrelated companies.

Supply of property

16. The term 'supply' is defined in wide terms to include 'provide, grant or confer'. The term 'property' is also given a wide meaning and includes the supply of services. The expression 'supply of property' is therefore wide enough to cover the case where a benefit is 'provided, granted or conferred' by one company to another. Where, for example, one company leaves uncollected credit balances it has with another company, and therefore available for the use of the other company, the creditor company has conferred a benefit on the debtor company. (subsections 136AA(1) and (3))

17. Representations have been made that:

(a) the fact that a debt is owed by one company to another is not in itself sufficient to satisfy the requirement that there should be a supply of property under an arrangement;

(b) there will be a supply of property by one company to another only if the first company supplied property directly to the other entity; and

(c) refraining from enforcing payment due from one company to another does not constitute the supply of property from one company to the other company.

18. These propositions are not accepted. The definition of the expression 'supply of property' to include a benefit conferred is a clear indication of the legislative intent to give that expression the broadest meaning consistent with the purpose of Division 13.

Arm's length dealing

19. The mere fact that two parties to an agreement are associates will not be determinative in concluding that they were not dealing at arm's length. On the other hand, there could be instances where dealings between unrelated parties could be on non-arm's length terms. (paragraphs 136AD(1)(c), (2)(c) and (3)(c))

20. In the case of a loan to a company, the question whether a particular dealing can be regarded as being on an arm's length basis would be determined by having regard to what terms an arm's length supplier of funds might seek if approached to supply funds to that company under the same circumstances.

Arm's length consideration

21. Representations have been made that an adjustment to income should not be made in respect of a loan granted by a resident parent company to a non-resident subsidiary because the parent company receives immediate and adequate compensation in the form of an increase in the value of the shares it holds in the subsidiary.

22. This proposition is not accepted as it would make Division 13 inapplicable to non-arm's length transactions between a parent resident company and a non-resident subsidiary despite the clear purpose of the legislation as set out in the Explanatory Memorandum and the Second Reading Speech. In this connection it is important that the emphasis in paragraphs 136AA(3)(c) and (d) is on the consideration in respect of the particular transaction that falls within the terms of the Division.

23. Where, for example, an arm's length lender would have received a regular interest payment throughout the life of a loan, Australian revenue would lose if assessable income is to be recognised only if and when dividends are actually distributed.

Group company transactions

24. We do not accept the view that because interest free finance arrangements are common between members of multinational enterprises, they should be regarded as arm's length arrangements. Nor should it be concluded that a transaction is on arm's length terms simply because it is a transaction that can only be entered into between related parties. The fact that arm's length parties would not have entered into similar agreements will, in most cases, confirm the non-arm's length nature of the dealings between the parties.

Non-availability of comparable transactions

25. Representations have also been made that, in the case of some transactions between members of a company group, it would not be possible to arrive at an arm's length consideration. It is stated that this is because similar transactions would not occur between unrelated parties and that Division 13 should not apply in these cases.

26. This argument is not accepted. Where an arm's length consideration cannot be ascertained, the legislation permits the Commissioner to determine an arm's length consideration on the information available. (subsection 136AD(4))

Division 13 adjustments and penalties

27. Representations have been made that Division 13, like Part IVA, is an anti-avoidance provision that carries with it stringent penalties and that the Commissioner should therefore apply it only where there is a clear purpose of tax avoidance.

28. However, as explained earlier, the primary purpose of Division 13 is to redress a situation where Australian revenue is denied its appropriate share of tax because of the non-arm's length nature of some transactions.

29. The proposition that Division 13 should only be applied very selectively, in view of the penalties that attach to an adjustment made under that Division, is not accepted. Penalties will not be taken into account as a factor in determining whether the provisions of Division 13 are to be applied.

30. It must be emphasised that the legislation contains provisions that enable the Commissioner to reduce penalties in the appropriate circumstances. Our general attitude on penalties in relation to adjustments made on assessments relating to the 1990-91 and earlier income years under Division 13 is set out in Taxation Ruling IT 2311. However, the application of the principles set out in Taxation Ruling IT 2517 to adjustments made under Division 13 may give a result that is more advantageous to the taxpayer. In these cases, the principles set out in Taxation Ruling IT 2517 may be adopted. The guidelines for penalties in connection with assessments relating to the 1991-92 income year will be set out in a subsequent Taxation Ruling. The self assessment penalty rules will apply for assessments relating to the 1992-93 income year and for subsequent income years.

Business purpose

31. An Australian entity may have a business purpose for granting an interest free loan to an offshore subsidiary. However, that in itself is not adequate to take the transaction outside the ambit of Division 13.

32. For example, an Australian parent may grant an interest free loan to an offshore subsidiary to enable it to accumulate profits for reinvestment. Where this is the purpose of the loan, Division 13 would be applied to attribute interest to the Australian parent even though there was a business purpose to the transaction.

33. However, in certain special cases, business purpose may be relevant in the exercise by the Commissioner of the discretion not to apply Division 13 to particular transactions. An example would be the case where the Commissioner decides that it would be appropriate not to apply Division 13 on the basis that a particular contribution of funds may be treated as equivalent to equity (see paragraphs 51-61).

Tax saving purpose and effect

34. Where a particular transaction has the effect of shifting profits out of Australia, the provisions of Division 13 could apply to adjust the tax liability having regard to the arm's length consideration.

35. It is not necessary that there be a tax saving purpose to the transaction for Division 13 to apply to it. However, where there is such a purpose, it could be expected that Division 13 would be applied.

36. The scope of Division 13 is not limited to cases where profits that would have arisen to an Australian entity are moved offshore to another entity. It would apply equally to cases where the Australian

entity does not receive offshore income that would ordinarily be expected to be received in an arm's length transaction.

Adjustment where interest would have been exempted from tax had it been actually paid

37. Prior to the introduction of the foreign tax credit system with effect from the 1987-88 income year, interest that was derived by an Australian company from a non-treaty country was exempt from Australian tax under paragraph 23(q) if foreign income was derived in a foreign country and was not exempt from tax in that country, and

(a) the Commissioner was satisfied that tax was payable and that arrangements had been made for its payment; or

(b) allowable deductions exceed the income and the Commissioner was satisfied that tax would have been paid in the foreign country if the interest income exceeded the allowable deductions from that income.

38. Generally, where interest income was derived from a treaty partner country, the treaty limit on tax on interest income would have applied. In these cases the interest income was subject to Australian tax with a credit for the foreign tax paid. However, in exceptional circumstances, the treaty limit was not applicable. An example was where, under the Australia/New Zealand treaty, interest was paid between associated parties - Article 9(3). In the latter cases the interest income would have been exempt from tax under paragraph 23(q).

39. The question has arisen whether Division 13 should not be applied to interest free loans granted by a resident company to a company resident in a non-treaty country or in circumstances where the treaty limit does not apply. The case for not applying Division 13 is based on the argument that Australian tax is not avoided as actual payment of the interest would have had the consequence that foreign tax would have been paid and the interest income would have been exempt from Australian tax.

40. However, the actual payment of the interest and the payment of foreign tax or the satisfaction of the expectation that tax would have been paid in the foreign country if the interest income had exceeded the allowable deductions from that income are essential for the exemption. Where interest has not been paid, the application of Division 13 will not be abrogated solely on the ground that the interest would have been exempt had it been paid.

Part B: the treatment of credit facilities or inter-company credit balances for which the creditor company is not adequately compensated

Ruling

41. As in the case of loans, Division 13 could apply to credit facilities or intercompany credit balances for which the creditor company is not adequately compensated.

Explanations

42. Representations have been made that a clear distinction should be drawn between:

(a) a case where a resident company has supplied property, such as money, to a non-resident under a loan agreement; and

(b) a case where credit balances are created for a resident company with a non-resident company for reasons other than the supply of funds or as a result of transactions between the non-resident and third parties.

43. In either case, it is common ground that the non-resident company has to repay the credit balance to the resident company. It is argued, however, that in the second case, there is no supply of property by the resident company under an international agreement.

44. This distinction is not fundamental to the application of Division 13 to attribute income to the resident company in relation to the credit balances it holds with the non-resident company.

45. The term 'agreement' has been given a very wide meaning in Division 13 and would include an implied 'understanding' by a creditor company to leave uncollected for a definite or undefined period credit balances that it holds with the debtor company. Where that understanding is between a resident company and a non-resident company, the understanding will constitute an international agreement.

46. Moreover, 'supply' is defined to include a reference to agreeing to supply. (paragraph 136AA(3)(a))

47. A supply of property will include, by definition, the supply of services. The definitions of 'supply' and 'services' interact to include as the supply of services the conferment of a benefit by one company

on another. The benefit, in this case, would be the facility provided by the resident company to the non-resident of having the use of the credit balances due to the resident company. The practical effect of this facility is such that an arm's length creditor who provides a similar facility would require that consideration be paid. (subsection 136AA(1))

48. The benefit provided by making available the use of a credit balance without adequate consideration is of the same nature as the benefit provided by granting an interest free loan. In either case, the arm's length interest would be the correct measure of the value of the benefit.

49. In this context, it is relevant that the Report of the OECD Committee on Fiscal Affairs, 1979, *Transfer Pricing and Multinational Enterprises,* recognises at pages 90-91 that it is normal for tax authorities to impute interest on intercompany indebtedness arising from the non-payment of accounts for periods in excess of that allowed to third parties under normal trade practice.

50. Accordingly, in determining whether Division 13 could apply to enable the Commissioner to make adjustments to the income or expenses of a resident, it would not be necessary to determine whether a credit balance held by a resident company with a non-resident constitutes a 'loan' provided by the resident or indebtedness that arose in any other circumstances. In either case, Division 13 enables an appropriate adjustment to be made having regard to an arm's length consideration.

Part C: the issues to be taken into account in determining whether an agreement that is in legal form a loan is to be treated as equivalent to a contribution to equity

Ruling

51. (a) The starting point in determining whether the Commissioner would exercise the discretion to apply Division 13 to a particular contribution of funds would be the legal relationship that is established by the transaction.

(b) Where the legal relationship established in a transaction is that between creditor and debtor, it could generally be expected that the transaction would be regarded as a loan to

which Division 13 would be applied to impute interest income.

(c) An example of a circumstance in which Division 13 would not be applied to impute interest income would be the case where the Commissioner is satisfied that the contribution of funds should be treated as equivalent to an equity investment.

Explanations

52. Representations have been made that before Division 13 can be applied to attribute arm's length interest on a loan, it is necessary to determine whether an agreement that is in legal form a loan agreement is, in essence, a contribution to equity.

53. Reference has been made, in this connection, to page 86 of the Report of the OECD Committee on Fiscal Affairs, 1979, *Transfer pricing and Multinational Enterprises*. The report points out that 'since for tax and other reasons equity contributions may be disguised as loans, a distinction has to be made between the two. Where it is determined that a financial transaction is a contribution to the equity of an enterprise, it follows that no interest is due'.

54. The OECD report acknowledged at page 89 that 'A hard and fast debt-equity rule would, however, not be appropriate for the solution of problems raised by the determination of the nature of a financial transaction'. It is recommended that 'a flexible approach be adopted in which the special conditions of each individual case would be considered'. This was because of the perception that 'financing practices differ too widely from one country to another and, within a given country, between different categories of enterprises'.

55. The question whether a loan, credit facility or credit balance is the equivalent of an equity investment is relevant at the stage where the Commissioner exercises the discretion whether or not to impute an arm's length consideration under Division 13.

56. In a resolution of this issue under Australian income tax law, the starting point would always be that a transaction would be taken to be a loan or a contribution to equity capital depending on the legal relationship that is established between the provider of funds and the recipient.

57. Where the legal relationship established in a transaction is that between a creditor and a debtor, it could generally be expected that Division 13 would be applied to attribute an arm's length consideration.

58. Where the agreement relating to the contribution provides for the payment or accumulation of interest, the agreement could generally be expected to be treated as a loan agreement.

59. In recommending a flexible approach, the OECD at pages 86-89 acknowledges that a number of countries use quite different criteria. It also recognises that, as a practical matter, some countries may be less concerned about the distinction between debt and equity than others. In this regard, the context in which the distinction is required is important. This includes:

(a) recharacterisation of interest received by a parent company as a dividend under constructive dividend rules;

(b) denial of deduction for interest paid to a parent by a subsidiary where a loan is recharacterised as a dividend under thin capitalisation or related legislation; and

(c) the determination of whether the withholding tax rate relating to the dividends is to be applied to a payment described as interest or to a part of that payment.

60. In the context of applying Australia's transfer pricing rules, the principal factors that will be taken into account in determining whether a particular loan agreement should be treated as equivalent to a contribution to equity are detailed below.

(a) **The legal effect of the transaction**

A loan would ordinarily create the legal relationships of creditor and debtor. Where the rights and obligations of the provider of funds are similar to the rights and obligations of a shareholder, this will be taken as a factor indicating that the contribution might be akin to the supply of equity capital. For example, the lender may have, in relation to the loan, voting rights, a return dependent upon profits, or other rights that usually attach to ownership.

(b) **Repayment of principal**

A loan repayable on demand or within a short period of time will not be considered as equivalent to equity unless other facts associated with the "loan" demonstrate conclusively that the "loan" is equivalent to a contribution to equity. Conditions regarding repayment of the loan that are not consistent with an equity investment would be a factor indicating that the loan is not equivalent to equity.

Similarly, where the contributor's claim to repayment of the contribution is not effectively subordinated to the claims of other creditors, this is a factor indicating that the contribution is not the equivalent of equity.

(c) **Purpose of the contribution**

The use of the funds by the borrower for investment in fixed assets of a long term nature for use as core assets of the business of the borrower may be a factor that might indicate that the funds are the equivalent of equity. This could be the case, for example, if it is customary in the particular industry or in the country in which the investment is made to use equity capital for the investments.

(d) **Debt equity ratio**

Where the ratio of debt to equity is very high compared to the average for the particular industry or in the country in which the investment is made, this would be one of the factors that might indicate that a part of the debt may be the equivalent of a contribution of capital.

(e) **Factors affecting the form of investment in a particular country**

An investor may have a need to maintain flexibility of investment having regard to the investment regulations applying in a particular country. An example would be the existence of barriers to repatriation of equity in the country of residence of the recipient of funds. Another example would be where a country imposes a minimum shareholding requirement by domestic investors. In these cases some contributions that are the equivalent of equity may be made in the form of loans to ensure that the percentage of the shareholding of domestic investors is not diluted.

(f) **Written loan agreement**

The absence of a written loan agreement in relation to the supply of funds will not be taken as determinative that the funds are a contribution to equity.

(g) **Ability to obtain finance from an unrelated third party**

Representations have been made that interest should not be attributed in the case of a loan if the circumstances of the borrower were such that an independent lender would not have provided credit to that borrower.

The OECD refers to this so called "independent lender test" in their report *Issues in International Taxation, No. 2, Thin Capitalisation, Taxation of Entertainers, Artistes and Sportsmen* pages 30 and 31. The report states that 'It may be necessary indeed to adopt an approach comparable to that which a banker would adopt, and to ask whether, considering the borrower's financial and economic condition, an independent bank would have provided the funds as a loan on the terms actually agreed between the parties.'

The OECD goes on to warn that 'Too rigid a reliance on this approach may not however be wholly satisfactory since it is possible that a parent company may have a better understanding of the profit potential of its own subsidiary than would a banker looking at the matter from the outside, and it might in consequence be reasonable to accept (if such was in fact the case) that an independent person who was as fully informed as the parent company might lend where a bank would hesitate to do so.'

Moreover, in the general run of business, the availability of a lender would also depend on matters such as the security and the consideration offered for the loan.

Consequently, the ability of the borrower to obtain finance from an unrelated third party would only be one of the factors to be taken into account in determining whether a loan is to be treated as the equivalent of equity.

Nevertheless, it is recognised that, at a particular time, the activity of a business may be of a type that no arm's length lender would lend to that business at that time even on deferred interest terms. An example of such an activity is the prospecting or exploration stage of a mining business. Typically, in this case, there will be no assets of the company that could be provided as security for a loan and the company would not have an income flow. This would be one of the factors that might indicate that the debt or a part of the debt may be the equivalent of a contribution to capital.

61. While these and other factors will be of relevance, what is important is the total picture that emerges from the transaction. The

taxpayer would have to establish that the transaction that bears the legal character of a loan is equivalent to a contribution to equity.

Part D: circumstances in which adjustments may be made under the associated enterprises articles of double tax agreements

Ruling

62. (a) The Commissioner may apply the provisions of Division 13 and/or the treaty provisions. Where the application of Division 13 would produce a result that is inconsistent with the treaty provisions, the latter will prevail.

(b) Profits may be attributed under the associated enterprises article of a double tax treaty to reflect interest that would be receivable on a loan under an arm's length arrangement.

(c) The Commissioner does not accept the proposition that Division 13 or the associated enterprises article of the double tax agreements should not be applied to attribute income merely because there is a contingency that the treaty partner country may not permit a corresponding adjustment to the debtor under the treaty. The treaties themselves set out the conditions under which the treaty partner country is required to make a correlative adjustment. The issue of correlative adjustments is a matter for resolution with the treaty partner country on the facts of each particular case.

(d) The Commissioner does not accept that actual or potential dividends constitute adequate consideration for the provision of an interest free loan.

Explanations

Interaction between Division 13 and the double tax agreements

63. The 'Associated Enterprises' article of a double tax agreement applies in the case of companies to parent and subsidiary companies and companies under common control. It authorises the taxation authority to adjust the profits of associated enterprises for taxation purposes where:

(a) there are special relations between the enterprises; and

(b) because of those relations, the correct profits arising in a state are not shown in the accounts.

64. The adjustment to profits is made on the basis of the profits that might have been expected to accrue to an enterprise if the associated enterprises were independent enterprises dealing wholly independently with one another.

65. When an adjustment is made under this article by one state to increase the profits of a company resident in that state, the treaty may provide for an adjustment to be made by the other state to the tax charged on the associated company that is a resident of that other state. However, the OECD Commentary points out that an adjustment has to be made in the other state only if it is justified both in principle and as regards the amount.

66. Where Australia increases the profits of a company under this article, the treaty partner country may adjust the tax charged on the associated company by reducing the profits of the associated company that are taxed in the treaty partner country.

67. Some double tax agreements provide that where Australia increases the profits of a company (Company A) by an amount under this article, the treaty partner country is to treat the corresponding profits of the associated company (Company B) as sourced in Australia and provide a credit to Company B for the Australian income tax paid on those profits by Company A. Examples of this type of adjustment are Article 19 of the Australia/United Kingdom Double Tax Agreement and Article 18 of the Australia/New Zealand Double Tax Agreement.

68. Subsection 3(2) of the *Income Tax (International Agreements) Act 1953* provides that a reference in an Agreement to profits of an activity or business shall, in relation to Australian tax, be read, where the context permits, as a reference to taxable income derived from that activity or business.

69. Paragraph 1 of each of the associated enterprises articles refers to conditions 'operative between the two enterprises in their commercial or financial relations which differ from those which might be expected to operate between independent enterprises dealing at arm's length with one another'. This indicates clearly that the adjustment to profits would include an adjustment to attribute an arm's length consideration for loans that are not on arm's length terms. It would also include an adjustment to profits to deny or reduce a deduction for the payment of excessive interest.

70. In the case of a transaction between a resident company and a subsidiary that is a resident of a treaty partner country, the

Commissioner may apply either the provisions of Division 13 or the treaty provisions. However, where the application of Division 13 would produce a result that is inconsistent with the treaty provisions, the treaty provisions will prevail.

71. This conclusion flows from the fact that section 4 of the Income Tax (International Agreements) Act provides that the ITAA is incorporated and shall be read as one with that Act. This is subject only to the provisions of the Income Tax (International Agreements) Act having effect notwithstanding anything contained in the ITAA (other than section 160AO or Part IVA) or in an Act imposing Australian tax.

72. It is generally unlikely that the application of Division 13 would produce a result that is inconsistent with the treaty provisions. This is because the treaties as well as Division 13 adopt arm's length considerations as the basis on which adjustments are made.

73. The argument has been made that, in determining whether interest is to be attributed to a parent company on an arm's length basis in relation to a loan granted to a subsidiary, it is necessary in the case of treaty countries to take into account potential or actual dividend flows from the subsidiary to the parent.

74. This argument is not accepted.

75. The OECD Commentary on Article 9, Associated Enterprises, of the OECD Model Convention itself envisages that adjustments may be of two types:

(a) what may be referred to as the primary adjustments to the profits of a company; and

(b) what are referred to as secondary adjustments that represent the distribution of those primary profits to the company that should actually have received them.

76. It is clear that the Article provides for adjustments to:

(a) the primary profits alone; or

(b) adjustments to the primary profits as well as the secondary adjustments.

77. The Article, therefore, envisages adjustments to the primary profits without taking into account potential dividend distributions out of those profits.

78. This approach is consistent with the well established principle that the taxable income of a company is calculated separately for each income year.

79. The approach is also consistent with the making of adjustments under Article 9 to profits to avoid the adverse consequences to revenue that would flow from a deferral, indefinite or otherwise, of the payment of dividends.

Part E: the manner in which arm's length interest will be calculated to determine whether a particular transaction is at arm's length and to attribute an arm's length consideration

Ruling

80. (a) All the relevant facts and circumstances surrounding an international agreement will be taken into account in determining an arm's length consideration for the supply or receipt of property under that agreement.

(b) The comparable uncontrolled pricing method will usually be the preferred method for determining an arm's length consideration.

(c) Internationally recognised benchmark rates, such as the London Inter Bank Offered Rate (LIBOR) in the case of Eurocurrency loans and the Singapore Inter Bank Offered Rate (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. These are basic rate indicators. Depending on the case, it may be appropriate to add a margin to these rates to reflect the credit standing of the borrower and the risk associated with the loan.

(d) Where moneys borrowed on arm's length terms are on-lent, the interest paid on the borrowings will be taken as generally indicative of arm's length interest in relation to the moneys on-lent.

(e) Deferral or non-payment of interest may be considered arm's length where interest has been paid regularly in the past and the borrower has financial difficulties such that an arm's length lender would, in the circumstances, have deferred or forgone receipt of interest.

Explanations

81. Division 13 has application to non-arm's length arrangements where:

(a) in the case of a supply of property, the consideration is less than the consideration that would have been received or receivable on an arm's length arrangement for the supply of that property; and

(b) in the case of acquisition of property, the consideration is more than the consideration that would have been given or agreed to be given on an arm's length arrangement for the acquisition of that property.

82. The comparison in either case is that between:

(a) the consideration that was in fact received or paid under the agreement; and

(b) the consideration that would have been received or paid if the agreement was between independent parties dealing at arm's length with each other.

83. All the relevant facts and circumstances will be taken into account in determining the arm's length consideration in relation to a loan. These would include:

(a) the nature and purpose of the loan;

(b) the market conditions at the time the loan was granted;

(c) the amount, duration and terms of the loan;

(d) currency in which the loan is provided and the currency in which repayment has to be made;

(e) security offered by the borrower;

(f) guarantees involved in the loan;

(g) credit standing of the borrower;

(h) situs of lender and borrower; and

(i) the prevailing interest rates for comparable loans.

84. The comparable uncontrolled pricing method will usually be the preferred method for determining the arm's length consideration.

85. Interest rates applicable to arm's length Eurocurrency term loans to corporate borrowers are usually calculated using the London Inter Bank Offered Rate (LIBOR) as the basic rate plus a margin that reflects the credit standing of the borrower.

86. The Singapore Inter Bank Offered Rate (SIBOR) is the usual reference rate for Asian currency loan facilities. This is again a basic rate and a margin may be added to reflect the credit standing of the borrower.

87. For Australian dollar loans, an analysis of the facts of a particular case will be required to determine which market interest rate is the appropriate reference rate.

88. The OECD publishes financial statistics of member countries, including prime rates and rates applicable to short and long term bank loans. These lending indicators offer some guidance on whether an interest rate is, on first analysis, likely to fall within an acceptable range of arm's length rates. However, these rates will not be determinative and a full analysis of the circumstances of the agreement will be required to compute the arm's length consideration in respect of the agreement.

89. A taxpayer may have borrowed funds from an independent third party specifically to on-lend to the party to the international agreement on interest free or low interest terms. In this case, the interest rate chargeable by the third party on the borrowed funds will be relevant to the calculation of the arm's length terms. However, adjustments to the interest rate may be required to reflect the other factors listed at paragraph 83.

90. Deferral or non-payment of interest may be considered arm's length where interest had been paid in the past and because of financial difficulties of the borrower circumstances arose where arm's length lenders would, in the circumstances, have deferred or forgone the payment of interest. This would be expected to relate to a desire on the part of the lender to preserve repayment of the principal. Non-payment of interest in these circumstances could be demonstrated to be in accordance with the arm's length principle where, for example, other arm's length lenders have deferred receipt of interest.

Part F: the exercise of the Commissioner's discretion to apply Division 13

Ruling

91. The application of Division 13 is not automatic and requires the exercise of the Commissioner's discretion provided under that Division.

92. In keeping with the legislative purpose of Division 13, it could be expected that the Commissioner's discretion would normally be exercised to attribute income to a resident company if a non-arm's length agreement has resulted in a shifting of income from Australia, regardless of the motive or purpose of the agreement.

Explanations

93. The application of Division 13 is not automatic and requires the exercise of the Commissioner's discretion provided under that Division. (paragraphs 136AD(1)(d), (2)(d) and (3)(d))

94. The Explanatory Memorandum states that the discretionary power was vested with the Commissioner to enable him 'to have regard to whether the use of non-arm's length prices has resulted in a shifting of taxable income from Australia'.

95. Taxable income is shifted from Australia if:

(a) income that should have been derived in Australia, for example on manufacture and sale of goods, is shifted offshore;

(b) income that should have been derived by a resident company from a non-resident company, for example on a loan or on intercompany credit balances, is not derived by the resident company, or the amount of the income derived is reduced to less than an arm's length amount; or

(c) deductions are claimed that would reduce the assessable income of a resident by more than an arm's length amount as in a case where excessive interest is paid on offshore loans.

96. The application of Division 13 is not limited to agreements that have a dominant tax avoidance purpose. This legislative intent is reflected in the Second Reading Speech on Income Tax Amendment Bill 1982. It was stated that:

> 'the fact that tax saving is not a key purpose of a particular arrangement or transaction is no reason why we, as a nation, should not be in a position to counteract any loss to the Australian revenue inherent in it'.

97. The Commissioner's discretion would, in keeping with the legislative intent, normally be exercised to attribute income to a resident company if a non-arm's length agreement has resulted in a shifting of income from Australia regardless of the motive or purpose of the agreement.

98. An example of an instance where the Commissioner's discretion would be applied so that no adjustment would be made under Division 13 relates to the cases where the Commissioner decides that it is appropriate not to apply Division 13 to attribute interest income on the basis that the contribution made should be treated as equivalent to equity.

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legislative references

ITAA 23(q); ITAA Division 13; ITAA 136AA(1); ITAA 136AA(3); ITAA 136AA(3)(a); ITAA 136AA(3)(c); ITAA 136(3)(d); ITAA 136 AC; ITAA 136AD; ITAA 136 AD(1);ITAA 136AD(1)(c); ITAA 136AD(2); ITAA 136AD(2)(c); ITAA 136AD(3); ITAA 136AD(3)(c); ITAA 136AD(4); ITAA 160AO; ITAA Part IVA ; Income Tax (International Agreements) Act 1953 3(2); Income Tax (International Agreements) Act 1953 Schedule 4 Article 9(3)