TD 2007/D20 - Income tax: where there is no excess debt under Division 820 of the Income Tax Assessment Act 1997 can the transfer pricing provisions apply to adjust the pricing of costs that may become debt deductions, for example, interest and guarantee fees?

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Draft Taxation Determination

Income tax: where there is no excess debt under Division 820 of the *Income Tax Assessment Act 1997* can the transfer pricing provisions apply to adjust the pricing of costs that may become debt deductions, for example, interest and guarantee fees?

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Ruling

1. Yes. The fact that an entity does not have excess debt,[1] such that the thin capitalisation provisions under Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997)[2] do not result in a disallowance of any portion of the amounts comprising the entity's debt deduction,[3] does not mean that the transfer pricing provisions cannot be applied to adjust the pricing of associated costs. Such costs include interest expenses, discounts on commercial paper or other costs that are directly incurred in obtaining or maintaining the debt funding. A reference in this draft Determination 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]

[1] 'Excess debt' as used in this draft Determination is a reference to debt to the extent it exceeds an entity's 'maximum allowable debt' under Division 820 of the *Income Tax Assessment Act 1997* as defined in section 995-1 of that Act.
[2] All references to Division 820 and its provisions are references to Division 820 and its provisions in the ITAA 1997.
[3] 'Debt deductions' are defined in section 820-40.
[4] All references to Division 13 are references to Division 13 of Part III of the ITAA 1936.
[5] See paragraph 17 of this draft Determination.

2. Conversely, the transfer pricing provisions cannot be applied to completely deny deductions for funding costs on debt that is not excess debt for the purposes of Division 820 merely because those deductions relate to a portion of the total debt funding that might be considered excessive when compared to the levels of debt and equity that would be required for the entity to be regarded as an independent entity dealing wholly independently in respect of its debt funding arrangements. To do that would defeat the operation of Division 820 which allows an entity in the course of determining whether its debt levels are excessive to select a statutory safe harbour debt amount[6] even though the safe harbour amount in the particular case is greater than the arm's length amount of debt determined by applying the arm's length principle in the transfer pricing provisions.[7] To that extent it is accepted that Division 820 modifies the operation of the arm's length principle embodied in the transfer pricing provisions.[8]

3. However, the existence of a 'safe harbour debt amount'[9] for the purposes of Division 820 does not prevent the Commissioner from determining an appropriate arm's length cost for all of the debt funding, including the portion of the debt funding that exceeds the arm's length capitalisation or gearing ratio calculated by applying the arm's length principle in the transfer pricing provisions to the facts of the particular case. It is clear from the wording of paragraph 820-40(1)(b) that the operation of Division 820 is limited to borrowing costs that the entity can deduct from its assessable income. Accordingly all provisions relevant to deductibility must be applied first before Division 820 comes into operation. The purpose of Division 820 is to set an upper limit on the amount of debt an entity can have and, where the debt level exceeds the statutory limit, to disallow a proportion of the debt deduction based on the ratio of the excessive debt amount to the average debt for the year of income. It follows that the application of the arm's length principle in the transfer pricing provisions is in accordance with the provisions of section 820-40 and does not conflict with the purpose of Division 820.

4. In determining the arm's length costs for the purposes of the transfer pricing provisions, the Commissioner will have regard, where necessary, to the levels of debt and equity that would be necessary in order for the borrowing entity to be financially independent. The safe harbour debt amount is a concept peculiar to the thin capitalisation provisions and is a mechanism used to deny deductions on excess debt, not to establish the arm's length costs relating to debt generally.

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[6] See sections 820-90, 820-190, 820-305 and 820-400. In the case of 'approved deposit-taking institutions' Division 820 safe harbours are based on a level of capital less than the arm's length capital amount producing a similar effect to a debt level in excess of the arm's length debt amount.

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

[8] Note that for non-bank permanent establishments, the attribution of equity and debt is based on the arm's length principle – see Taxation Ruling TR 2001/11.

[9] See the definition of that term in section 995-1 of the ITAA 1997.

5. Part IVA of the ITAA 1936 will not apply to an entity merely because it has taken advantage of the safe harbour debt amount under Division 820. 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 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. Generally speaking, such a conclusion would depend on some artificiality of manner, divergence of form from substance, or lack of change in the financial position of the taxpayer and connected persons, as well the result in relation to the operation of the Act. In colloquial language, Part IVA will apply to contrived arrangements to bring a taxpayer within the safe harbour.[10]

6. The following simplified examples are intended to illustrate the respective fields of operation of the transfer pricing provisions and Division 820.

Example 1 – transfer pricing provisions do not defeat the operation of the thin capitalisation provisions

7. *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 double taxation agreement. Being an industrial company and not an ADI,*[11] *Aus Co is an 'inward investment vehicle (general)' for the purposes of Subdivision 820-C.*

8. *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),*[12] *of $400m borrowed from For Co at an interest rate of 10%; and*
- *equity of $100m.*

9. *Aus Co's only debt deductions are for the interest incurred on its $400m debt, meaning that it has $40m of debt deductions for the income year. Its interest rate is set by reference to the rate at which For Co is able to borrow and at which Aus Co could borrow if it were financially independent.*

10. *Assume that, applying the arm's length principle embodied in Division 13 and the relevant associated enterprises article, an arm's length amount of debt for Aus Co would be $334m if Aus Co were to be regarded as financially independent and able to borrow in its own right. On that basis, Aus Co might be considered to have excessive debt of $66m. However, for the purposes of Division 820, Aus Co has excess debt of only $25m because of the operation of the safe harbour debt amount rules.*

11. *Section 820-220 operates to deny $2.5m of Aus Co's $40m debt deductions because, by reference to the statutory safe harbour, it has excess debt of $25m, which is 6.25% of its adjusted average debt for the particular year of income. The transfer pricing provisions would not be applied to deny any further debt deductions notwithstanding that Aus Co might be considered to have $66m excessive debt by reference to the arm's length principle.*

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[10] Law Administration Practice Statement PS LA 2005/24 contains comprehensive guidance on how the Commissioner interprets and administers Part IVA of the ITAA 1936.
[11] Within the meaning of section 995-1 of the ITAA 1997.
[12] For the purposes of the example adjusted average debt is the same amount as the average debt.

Example 2 – transfer pricing provisions can adjust the pricing of debt costs notwithstanding there is no excess debt under the thin capitalisation provisions

12. *Assume instead that Aus Co has $300m of adjusted average debt*[13] *and $100m of equity, producing a safe harbour debt amount of $300m. The interest rate on Aus Co's debt to For Co is 20%, so that, before applying the transfer pricing provisions and Division 820, Aus Co has debt deductions of $60m. The interest rate has been set much higher to reflect the fact that Aus Co is too thinly capitalised for the industry in which it operates.*

13. *The transfer pricing provisions in Division 13 and the relevant associated enterprises article would be applied to reduce Aus Co's debt deductions to an amount based on the interest rate that Aus Co could have obtained if it were financially independent, namely 10%. This results in a reduction in the interest deduction from $60m to $30m. Accordingly this adjustment to interest deductions reduces the debt deduction for the purposes of Division 820*[14] *to $30m.*

14. *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

15. When the final Determination is issued, it is proposed to apply both before and after its date of issue. The Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
28 November 2007

[13] For the purposes of the example adjusted average debt is the same amount as the average debt.
[14] See section 820-40.

Appendix 1 – Explanation

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

Explanation

Transfer pricing provisions

16. Section 136AD of the ITAA 1936 empowers the Commissioner of Taxation, where various conditions are met, to make a determination having the effect that an arm's length consideration is deemed to apply, for the purposes of the Act, in respect of property[15] supplied or acquired.[16] In ascertaining the arm's length consideration of certain property, for example loans or guarantees, the creditworthiness, including the debt to equity capitalisation, of a taxpayer may be relevant.

17. Provisions of Australia's tax treaties, notably the business profits article and the associated enterprises article,[17] contemplate adjustments to profits[18] 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.

18. Division 13 and the relevant provisions of Australia's tax treaties are referred to as the 'transfer pricing provisions' in this draft taxation determination.

19. Subsection 136AB(1) of the ITAA 1936 states that 'nothing in the provisions of this Act other than this Division shall be taken to limit the operation of this Division'. Furthermore, the arm's length consideration ascertained under section 136AD of the ITAA 1936 is deemed to apply for all purposes of the Act.[19]

20. Australia's tax treaties are included as schedules to the *International Tax Agreements Act 1953* (the Agreements Act). Subsection 4(2) of the Agreements Act states that the Agreements Act has effect notwithstanding anything inconsistent with the provisions in the Act, other than section 160AO and Part IVA of the ITAA 1936, or in an Act imposing Australian tax.

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[15] Property includes services for this purpose – see the definition of 'property' in subsection 136AA(1) of the ITAA 1936.
[16] In certain circumstances subsection 136AD(4) of the ITAA 1936 applies and the arm's length consideration shall be deemed to be such amount as the Commissioner determines.
[17] For example, Articles 7 and 9 of the USA Convention in Schedule 2 of the Agreements Act.
[18] Section 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.
[19] Refer to subsections 136AD(1), (2) or (3) of the ITAA 1936.

Thin capitalisation provisions

21. Division 820 operates to deny debt deductions[20] for an entity 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.[21] The maximum allowable debt is the greater of certain safe harbour amounts or an arm's length amount test.[22] The statutory safe harbour amount can exceed the arm's length debt amount.[23]

22. 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 Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001 (the EM) which inserted Division 820 in the ITAA 1997.

Relationship between transfer pricing and thin capitalisation provisions

23. The EM considered the inter-relationship between the thin capitalisation rules and the transfer pricing provisions. Paragraph 1.78 of the EM states that:

> …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…

24. Paragraph 1.79 of the EM states:

> …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.

25. 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.

26. This interaction is discussed in Taxation Ruling TR 2003/1.[24] The Ruling states that the transfer pricing provisions are left to operate on questions of profit allocation and rates of dealing.[25]

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[20] A 'debt deduction' is defined in subsection 820-40(1).
[21] 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.
[22] For certain entities there is also a world wide gearing test.
[23] For example, refer to section 820-90 for non ADIs.
[24] TR 2003/1 Income tax: thin capitalisation – applying the arm's length debt test.
[25] TR 2003/1, at paragraphs 91 to 93.

27. The Ruling states 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.[26]

28. The transfer pricing provisions 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. In this sense, the otherwise deductible rule in paragraph 820-40(1)(b) is not absolute. The Act, read in context, requires Division 820 to operate to achieve its purpose. That means that there is an implied limitation on the transfer pricing provisions to the extent of the field of operation of Division 820.

29. Except to that extent, Division 820 does not apply to defeat the operation of the transfer pricing provisions. An entity cannot circumvent 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 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.

[26] 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.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.

Alternative view 1

30. An alternative view is that, where the thin capitalisation provisions under Division 820 do not result in any adjustment to the debt deduction of an entity, the transfer pricing provisions cannot be applied to adjust the pricing of associated costs, such as interest expenses and guarantee fees. The basis for this view is that the thin capitalisation regime is an exclusive code for the purposes of allowing debt deductions and that includes pricing them.

31. The Commissioner does not accept this view. The EM states at paragraph 1.76 that the thin capitalisation rules make up a comprehensive regime in respect of debt deductions. However, paragraph 820-40(1)(b) and paragraph 1.79 of the EM make it clear that the rules will apply to an amount of a debt deduction which the entity can, apart from Division 820, deduct from its assessable income for that year. The legislation is clearly contemplating amounts which are deductible under all the relevant provisions of the Assessment Act. An amount otherwise allowable would include only those costs which satisfy the arm's length principle embodied in Division 13 and Australia's tax treaties.

Alternative view 2

32. A second alternative view that has been expressed is that the capitalisation or gearing ratio required for the purpose of applying the arm's length principle under the transfer pricing provisions should be calculated by reference to the thin capitalisation rules in Division 820. That is, because there is no Division 820 excess debt then the actual capitalisation or gearing must be used for the purpose of applying the transfer pricing provisions to determine the arm's length price of the costs.

33. The Commissioner does not accept this view. There is no authority in Division 820 or elsewhere in the Act to support the view that Division 820 applies to determine the capitalisation or gearing ratio for the purposes of Division 13 or comparable provisions of Australia's tax treaties. Allowing the application of the arm's length principle in relation to the pricing of debt funding is consistent with the differing roles of Division 820 which is to disallow deductions on excess debt (calculated on a concessional basis relative to the arm's length principle) and the transfer pricing provisions as they apply to price costs in relation to debt generally.

Appendix 3 – Your comments

34. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date. (Note: the Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel or relevant Tax officers. The Tax Office may use a version (names and identifying information removed) of the compendium in providing responses to persons providing comments. Please advise if you do not want your comments included in the latter version of the compendium.)

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2001/11; TR 2003/1; TR 2006/10

Subject references:

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

Legislative references:

- ITAA 1936
- ITAA 1936 Pt III Div 13
- ITAA 1936 136AA(1)
- ITAA 1936 136AB(1)
- ITAA 1936 136AD
- ITAA 1936 136AD(1)
- ITAA 1936 136AD(2)
- ITAA 1936 136AD(3)
- ITAA 1936 136AD(4)
- ITAA 1936 160AO
- ITAA 1936 Pt IVA
- ITAA 1936 177D
- ITAA 1997 8-1
- ITAA 1997 Div 820
- ITAA 1997 820-40
- ITAA 1997 820-40(1)
- ITAA 1997 820-40(1)(b)
- ITAA 1997 820-90
- ITAA 1997 820-115
- ITAA 1997 Subdiv 820-C
- ITAA 1997 820-185(3)
- ITAA 1997 820-190
- ITAA 1997 820-195
- ITAA 1997 820-215
- ITAA 1997 820-220
- ITAA 1997 820-305
- ITAA 1997 820-400
- ITAA 1997 995-1
- International Agreements Act 1953
- International Agreements Act 1953 3(2)
- International Agreements Act 1953 4(2)
- International Agreements Act 1953 Sch 2

Other references:

- Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001
- PS LA 2005/24

ATO references

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