DLA PIPER

AUSTRALIAN TAX UPDATE

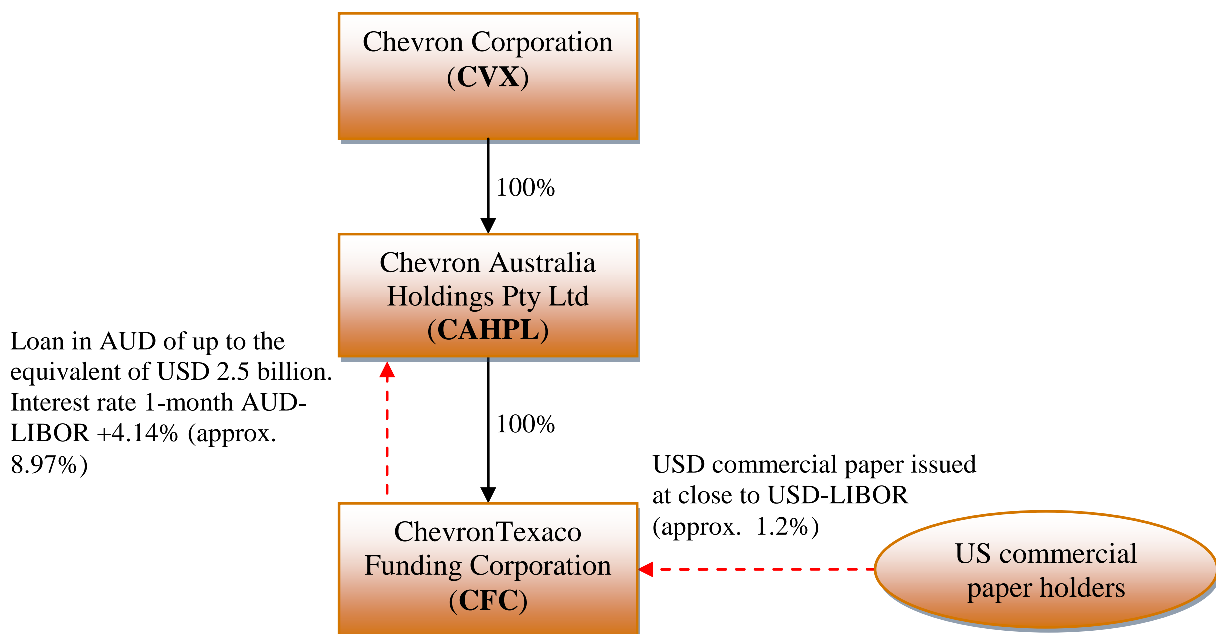
CHEVRON AUSTRALIA HOLDINGS JUDGMENT

PROVIDES CRITICALLY IMPORTANT GUIDANCE ON BOTH THE 'OLD' AND 'NEW' TRANSFER PRICING LAWS IN AUSTRALIA

BACKGROUND & INTRODUCTION

The much anticipated decision in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4)* [2015] FCA 1092 was handed down by Robertson J on 23 October 2015. At the heart of the case was a related party loan (**Credit Facility Agreement**) between a US subsidiary and its Australian parent, which was ultimately owned by Chevron Corporation (**CVX**), a US company listed on the New York Stock Exchange. The Commissioner issued determinations and amended assessments in respect of the 2004 to 2008 tax years on the basis that the interest rate on the five year loan was not an arm's length rate thereby giving rise to transfer pricing benefits to Chevron Australia Holdings Pty Ltd (**CAHPL**), which claimed interest deductions on the loan.

The structure was broadly (ignoring other interposed entities):



The decision involved the consideration of:

- Transfer pricing rules under the now superseded Division 13 of the *Income Tax Assessment Act 1936* (**ITAA 1936**);
- Transfer pricing rules under Subdivision 815-A of the *Income Tax Assessment Act 1997* (**ITAA 1997**), which were introduced with 'retrospective' application in 2012;
- Issuing alternative assessments which relied upon alternative transfer pricing provisions;
- The status of articles in double tax agreements as separate and independent powers of tax or allocation of tax rights; and
- The constitutional validity of enacting Subdivision 815-A with retrospective application.

DIVISION 13

Division 13 of the ITAA 1936 was, for many years, the primary transfer pricing provision in Australian tax law.

The preconditions for the operation of Division 13 were:

- A taxpayer acquired property (broadly defined) under an international agreement;
- The Commissioner is satisfied that the parties to the agreement (or any 2 of them) were not dealing at arm's length;
- The taxpayer agreed to give consideration in respect of the acquisition that exceeded the arm's length consideration in respect of the acquisition; and
- The Commissioner determined that the provision applies.

The effect if such a determination is made is that for all purposes of the ITAA 1936 and ITAA 1997, consideration equal to the arm's length consideration shall be deemed to be the consideration in respect of the acquisition.

In CAHPL's case, the Commissioner made such a determination in respect of each of the 2004 to 2008 tax years.

Although the Commissioner submitted that the Court could undertake an analysis of a "hypothetical" agreement between arm's length parties to determine the arm's length consideration, Robertson J specifically rejected this proposition. In so doing he said that the arm's length consideration must relate to the same rights or benefits conferred under the actual agreement to which the determination relates [at paragraph 76]. For example, it was not open to the Commissioner to argue that the loan in this case should have been denominated in USD.

In undertaking the analysis, the Court was careful to stress that it was not undertaking a "reconstruction of the transaction" but rather *"the exercise, although hypothetical, should remain close to undertaking the actual loan"*.

The Court held that consideration refers to not only the pricing of the interest rate on the loan but also other consideration, such as the giving of security or covenants by the borrower [at paragraph 84].

The loan provided by CFC was not secured and no operational or financial covenants were provided by CAHPL in respect of the loan. Giving of such security would result in a lower interest rate being provided. The Court held that arm's length parties would have given such consideration in respect of the loan, therefore the interest rate was overstated as a result [at paragraph 87].

The Court then went on to consider which characteristics of the actual parties to the agreement must be considered in determining the arm's length consideration, in this case what the consideration for the loan should be. The "hypothetical" requires the negation of any connection between the parties in formulating the attributes of the hypothetical independent parties. This required negating the parent subsidiary relationship between CAHPL and CFC and also the common ownership of the entities by CVX. A key aspect of this was that any implicit guarantee by CVX of the debt held by CAHPL must be ignored in undertaking the statutory analysis. This approach may be in contrast to the OECD recognition of 'implicit support' of parents.

In determining what represents arm's length consideration, both CAHPL and the Commissioner called a number of witnesses to support their analysis. The qualifications of witnesses varied from economists, accountants, investment bankers, credit rating agency analysts and senior finance executives from other corporates.

The Court was critical of much of the evidence adduced by the economists surrounding the rate at which an independent party would have borrowed due to the analysis not being undertaken in accordance with the statutory language which the Court held must be applied. In future cases, the briefing of experts will need to carefully consider the scope and questions on which an economist should provide evidence.

Roberston J ultimately determined that the correct perspective in assessing the statutory questions is from that of a commercial lender [paragraph 503]. On the evidence provided, the Court was not satisfied that CAHPL had proved that the consideration did not exceed the arm's length consideration.

Further, on the facts of the case, providing the loan in the amount of USD $2.5 billion on the terms that were provided resulted in the credit worthiness of CAHPL being lower than it otherwise would have been. It was held that this did not permit inflated consideration to be arm's length consideration under Division 13.

SUBDIVISION 815-A

Subdivision 815-A was largely introduced in response to the decision in *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74, where the court held that the associated enterprises articles in the various double tax agreements to which Australia is a party do not provide a separate head of power under which the Commissioner may levy tax. This conclusion was confirmed in the current case. Instead, Subdivision 815-A is designed to provide the domestic law power required to give effect to the associated enterprises articles in the double tax agreements.

CAHPL argued that the double tax agreement in question, being the Australia / US double tax agreement, does not contain an associated enterprises article as that term is defined in Subdivision 815-A. The definition in Subdivision 815-A relies on the Australia / UK double tax agreement article as the form required to invoke the subdivision. In this regard the court held that it is sufficient that an article in a double tax agreement had the same "gist" (not necessarily the same detail) as the article in the Australia / UK double tax agreement to be subject to the subdivision.

CAHPL also made various submissions relating to the applicability of the article in the Australia / US double tax agreement to its circumstances. These included that the interest article of the agreement was exhaustive in respect of interest and that no other article could apply, that CAHPL did not participate in the capital or management of CFC and therefore was not an associated enterprise, that article 1 prevented the treaty from increasing a CAHPL's tax liability. Each of these arguments was rejected by the Court and the court held that the associated enterprises article applied in the circumstances.

In determining whether a "transfer pricing benefit" arises under the subdivision, the Court considered the relevant test, having regard to the Australia / US double tax agreement, as whether the taxable income of CAHPL would be greater than its actual amount but for the conditions mentioned in the article and the amount of the benefit is the difference between the amount that might have been expected to have accrued, but by reason of those conditions did not so accrue.

Contrary to CAHPL's submissions, it is not necessary for the Commissioner to separately identify each of the conditions which he considers operated and the individual affect that each had on the profit accruing to CAHPL.

The Court stated that the test under Subdivision 815-A differs to that under Division 13. Rather than using the terms of the agreement between CAHPL and CFC as the starting point and not being able to consider if those terms (apart from consideration) are terms that arm's length parties would transact with, the whole arrangement is to be considered. In this case the Commissioner identified some eleven conditions that operated such that the amount of profits differed to that which might have been expected to accrue in their absence.

These conditions included:

- the relationship between CAHPL, CFC and CVX;
- the terms of the loan including interest rate, duration, currency and lack of security;
- the sole purpose of incorporating CFC and its commercial paper program was to fund CAHPL;

- the credit profiles of CAHPL and CFC could be controlled by decisions made by CVX;
- CFC profited by lending to CAHPL at a high interest rate; and
- the higher the interest rate charged by CFC, the more profit CAHPL stood to make.

While the Court did not accept that the currency of the loan differed from what might have been expected based on the evidence before it, it accepted that the conditions relating to the loan satisfied the statutory question. Therefore, under subdivision 815-A, it is open to the Commissioner to consider all conditions of the arrangement in determining what might have been expected to occur between independent parties.

Similar to the consideration under Division 13, the Court also considered what attributes of the parties to the transaction are to be imported into the hypothetical independent parties to ascertain what might reasonably be expected to have occurred. The Court held that, unlike under Division 13, it was appropriate under Subdivision 815-A to have regard to the relationship that parties have to each other, their parent entities and subsidiaries. Therefore, it is permissible to have regard to matters such as implied parental guarantees over the debt in determining what might reasonably be expected to have occurred. However, on the facts of the particular case the Court held that such implied support had limited implications for the terms of the loan.

Finally, CAHPL also submitted that where the article in the double tax agreement referred to "the amount of profit", it must be construed in the normal sense rather than being read as relating to taxable income. That is, the profits of the enterprise must be less as a result of the condition, if certain tax provisions result in that amount not being assessable that should not be taken into account. CAHPL made particular reference to significant dividends it received from CFC which resulted in its profits for the years in question being no less than they would have been if the loan was on terms that might reasonably have been expected between independent parties. However, due to the operation of section 23AJ of the ITAA 1936 at the time, those dividends were non-assessable non-exempt income of CAHPL and therefore did not increase CAHPL's taxable income.

The Court held that profit is to be construed according to its ordinary meaning, however, it is not permissible to take a 'net profit' approach to the circumstances. In this case the Court held that the dividends could not be offset against the reduced profits caused by the interest rate being higher than what might reasonably be expected between independent parties.

CONCLUSION ON 815-A

The key points on the Court's approach to Subdivision 815-A are:

- the Court can have regard to all the conditions that operate, not only the consideration under the agreement;
- the hypothetical independent parties still have the relationship characteristics of parents and subsidiaries that may have an impact of the terms of the agreement; and
- a reduction in profits by virtue of non-independent party conditions cannot be offset by profits arising in another way.

PENALTIES

Due to the transitional provisions associated with Subdivision 815-A, no penalty could arise in respect of a transfer pricing benefit under that subdivision. Therefore it was only the transfer pricing benefit under Division 13 that could give rise to a penalty.

The Commissioner imposed a 25% penalty on CAHPL on the basis that it entered into the arrangement for the dominant purpose of obtaining a "scheme benefit", being the transfer pricing benefit under Division 13.

The Court held that CAHPL's dominant purpose was not the refinancing of its debt, as argued by CAHPL, but rather to obtain the scheme benefit.

This was because the debt could have been refinanced on arm's length terms and evidence before the Court that regard was had to the tax benefit at the time.

INTERACTION WITH THIN CAPITALISATION

CAHPL submitted that the Court should not allow the arrangement considered under Subdivision 815-A to reduce the level of debt that the arrangement

relates to in determining what independent parties might reasonably be expected to have done. CAHPL put forward two arguments in support of this:

- the level of debt an entity can claim deductions in respect of is determined under Division 820 (thin capitalisation) and that Subdivision 815-A should not interfere with the operation of that Division;
- Subdivision 815-B, introduced after Subdivision 815-A and the replacement for Division 13, expressly contains a reconstruction power in determining whether a transfer pricing benefit arises. As Subdivision 815-A does not contain an express power, the absence of such a provision indicates a lack of legislative intent in this regard.

However, the Court held that neither of these propositions is supported by the words of Subdivision 815-A. In particular, it held that if the level of debt between independent parties is less than the amount that actually occurred, which would likely result in a higher interest rate on the debt, the transfer pricing benefit is to be determined having regard to that lesser amount. The thin capitalisation provisions then operate separately to disallow any debt deductions where the maximum debt level is exceeded.

In relation to the express reconstruction power in Subdivision 815-B, the Court found that the terms of the legislation enacted after the legislation in question, in particular the absence of an express power in the preceding legislation, should not impliedly limit the scope of the legislation. Regard must always be had to the terms of the legislation.

CONSTITUTIONAL VALIDITY OF SUBDIVISION 815-A

CAHPL submitted that in so far as Subdivision 815-A sought to tax CAHPL on amounts that arose in income years prior to its enactment, it was not constitutionally valid because it was an arbitrary imposition which was beyond the scope of section 51 of the Constitution.

In deciding that the subdivision was constitutionally valid the court held that:

- The tax imposed as a result of Subdivision 815-A was not arbitrary as it was imposed based upon ascertainable criteria with sufficiently general application;
- It was not relevant that the law applied to a specific class of entities because the circumstances which invoked its application must have occurred prior to its enactment; and
- It was not necessary to include a provision relating to assessment as the *Income Tax Act 1986*, the ITAA 1936 and the ITAA 1997 operated on the amended amount that arose due to the enactment of the subdivision.

ALTERNATIVE ASSESSMENTS

CAHPL submitted that the Commissioner was unable to rely on the determinations and assessments under Division 13 once a determination and assessment was made under Subdivision 815-A. Consistent the previous authority allowing the Commissioner to issue assessments in the alternative, but only ever recovering tax once, the Court held that there was nothing preventing the Commissioner making determinations under both Division 13 and Subdivision 815-A in the alternative.

CONCLUSION

The Chevron decision provides critically important guidance on both the 'old' (Division 13) and 'new' (Subdivision 815-A) transfer pricing laws in Australia. While not dealing specifically with Subdivisions 815-B to D, the decision is highly relevant to the deductibility of interest on all cross border financing arrangements and deals with several key related issues including thin capitalisation, double tax treaties, penalties, constitutional and procedural issues.

On one view, the decision is very much based on its special facts, but it provides much precedential guidance on key transfer pricing issues, particularly for cross border financing arrangements.

We would expect the decision to be appealed given the significant amounts involved (approximately $270 million including penalties and interest) and the challenges of benchmarking cross border related party loans.

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