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Tax insights

Deconstructing the Chevron Transfer Pricing Case

Snapshot

The Federal Court issued its much anticipated decision in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* ([2015] FCA 1092) on 23 October 2015. Robertson J upheld transfer pricing assessments against Chevron Australia Holdings Pty Ltd (CAHPL) related to interest payments made to its US subsidiary, Chevron Texaco Funding Corporation (CFC), under an intercompany loan arrangement.

CFC lent CAHPL the AUD equivalent of USD2.5 billion on an unsecured basis at an interest rate of AUD LIBOR plus 4.14% under a Credit Facility agreement entered into in June 2003 with a maturity date of 30 June 2008. CFC had raised the funds at rates of interest at or below USD LIBOR (approximately 1 to 2%) through an issuance of USD commercial paper with a credit guarantee provided by Chevron Inc, the ultimate parent of the group.

The Court held that CAHPL had not shown that the interest paid under the Credit Facility Agreement was equal to or less than arm’s length. CAHPL therefore did not prove that the amended assessments imposed by the Commissioner under Division 13 were excessive.

The case was extremely complex involving multiple facets of tax law and was heard over some 21 court days making it one of the lengthiest tax cases heard in Australia. The case involved more than 20 witnesses and experts (from corporate banking, rating agencies, academia, oil and gas industry and transfer pricing specialists).

The Big Picture

The Chevron case should be seen in context as the first big dollar transfer pricing case taken by the Australian Taxation Office (ATO) to the Federal Court. It is also the first test of the retrospective Subdivision 815-A laws introduced by the Australian Government in 2012, explicitly on the request by the ATO to shore up Australia's transfer pricing regime after the loss by the ATO in the SNF Australia case in the Full Federal Court (which was argued under the old Division 13 regime). It also should be seen as part of the ATO's wider messaging that it is willing to take multinationals to Court on transfer pricing, notwithstanding the ATO's general preference to reduce extensive 'paper wars' with multinationals and agree matters outside of a Court context.

In that regard, this win may embolden the ATO to pursue transfer pricing audits, particularly for inbound financing arrangements. It is also relevant to note that while the dollars at stake in this case are large, as a consequence of major capital project developments in the resources and infrastructure sectors in Australia in recent years, there are other large funding arrangements in the market, which may now be in the sights of the ATO.

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Furthermore, from a global perspective, the case has significance as an interpretation of the arm's length principle in the context of financing, and is probably the most significant case since the GE Capital Canada Inc (2009) case in Canada. Issues common to both cases include whether the potential for credit support by parent/affiliate entities (in the absence of legally binding guarantees) should be considered under the arm's length principle, and the appropriate benchmarking approach for loan/guarantee fee transactions. In addition, global commentators will be interested in the judge's view on the ability of the arm's length principle to look beyond the legal form of a transaction and determine pricing based on the actual conduct of the parties, and as discussed below, whether such an approach is in fact a 'reconstruction' or simply pricing the actual arrangement.

The Court's view on all of the above issues, and potentially the views of the Full Federal Court if the case is appealed, may have resonance with the OECD as it further considers (in the context of the BEPS project) the application of the arm's length principle to intra-group financing arrangements in 2016.

The facts

The judgement provides limited detail of the relevant facts, however, it appears that the arrangements included the following:

- CFC was a wholly owned subsidiary of CAHPL. CFC appears to be a resident of the United States and not a resident of Australia
- CFC borrowed an amount of USD2.5 billion from the commercial paper market at rates of interest at or below USD LIBOR (approximately 1 to 2%)
- CFC obtained a guarantee from Chevron Inc, the ultimate parent of the group
- CFC provided an intercompany loan to CAHPL for the AUD equivalent of USD2.5 billion, under the Credit Facility agreement
- The interest rate under the Credit Facility agreement was AUD LIBOR plus 4.14%
- CAHPL drew down funds of approximately USD2.5 billion in two tranches. Interest payments were also effected through "debits to the US dollar bank account …calculated by reference to the AUD principal amount borrowed"
- It appears that there was no interest withholding tax on the interest payments from CAHPL to CFC, presumably as a result of Section 128F(8)
- During cross-examination, it was indicated that "CFC was not taxable in the US" on the interest income
- As a result of the interest differential, CFC generated profits and it paid dividends to CAHPL, which were exempt from tax in Australia
- CAHPL in turn paid dividends to its shareholder.

Summary

While this case was based on Australia's former transfer pricing rules, it is expected to have a significant impact on the future interpretation of the arm's length principle in Australia, not only in relation to financial arrangements but also in respect of other related party transactions Some of the key implications include:

Article 9 not a separate taxing power

Article 9 (the Associated Enterprises article in the relevant double tax treaty) does not confer a separate or alternative taxing right outside the scope of the domestic transfer pricing rules, thereby highlighting the importance of the retrospective nature of Subdivision 815-A. This finding is contrary to the ATO long held view, and consistent with obiter in the SNF Australia case.

Broad view of consideration

The term "consideration" in Division 13 is broader than just the price (interest rate), and allows the Commissioner to make adjustments to other factors (security and loan covenants in this case) that could have an impact on the price.

Can substitute arm's length conditions

In applying the hypothesis required under Subdivision 815-A, the actual conditions that operated between the relevant parties must be compared with those conditions which might be expected to operate between independent parties dealing at arm's length. In doing so, the Court held that the Commissioner took into account alternative conditions (such as security over assets and other financial covenants) without the applying the specific reconstruction provisions. Given the similarities between Subdivision 815-A (which applies from 2004 to 2013) and the current transfer pricing provisions in Subdivision 815-B, this finding suggests that the Commissioner has extensive powers to "rewrite" or "recharacterise" elements of related party transactions, without the need to prove that the specific requirements for reconstruction (in s 815-130) are met. This principle could have implications beyond financing to other types of transactions (e.g. intellectual property, services, tangible goods) whereby the Commissioner or the Court can "rewrite" or "recharacterise" certain matters in determining the arm's length pricing.

Loan was "not sustainable"

In cross-examination, it was accepted by an employee of CAHPL that the loan of the Australian dollar equivalent of USD2.5 billion at an interest rate of 8.97% was "not sustainable".

Implicit credit support

The Court considered whether 'implicit credit support' provided by associate or parent entities should be taken into account in applying the arm's length principle, however Robertson J accepted CAHPL's submission that such implicit credit support had "little if any impact on pricing by a lender in the real world".

Expert witness evidence "unrealistic"

The absence of loan covenants and security was a significant factor in the findings of the Court. The fact that the key expert witnesses for CAHPL did not price a loan with security and financial covenants meant that the Court found their evidence to be 'unrealistic'. This highlights the requirement for all terms and conditions included in related party agreements to be arm's length, robust comparability analysis and also for transfer pricing analyses to be "founded in the statutory language" of the relevant provisions.

From a global perspective, this case may have wider impact given the current lack of transfer pricing guidance on financing transactions.

Onus of proof

The onus of proof is on the taxpayer to show that the ATO's transfer pricing determinations are incorrect and therefore the tax assessments are excessive. The Court focused on whether the taxpayer had discharged this burden of proof, and was not able to conclude that the taxpayer had shown the ATO's assessments to be excessive.

Currency

Given the substantial impact of the currency of a loan on the interest rate, it is significant that the potential impact of foreign exchange gains and losses for the borrower was accepted as valid reason for denominating the loan in Australian dollars.

Evidence from internal communications

In determining that a scheme benefit applied, and therefore the application of 25% penalties, evidence from internal emails and communications between staff of CAHPL and the Chevron head office were critical in the Commissioner's case.

From a global perspective, this case may have wider impact given the current lack of transfer pricing guidance on financing transactions. Furthermore, it may influence the development of the OECD's views as it progresses with its plan to issue more guidance in this area in 2016.

There seems to be a high likelihood of appeal, potentially on issues such as whether Division 13 allows a wide interpretation of the term 'consideration' to include security and other financial covenants, and under Division 815, whether the Court is inappropriately 'reconstructing' the transaction.

We provide below a detailed view on specific issues covered in the case and our observations on what multinationals should do having regard to this decision.

Division 13

Arm's length consideration

Robertson J referred to the decision of the Full Federal Court in SNF and accepted its findings in that case in relation to the statutory hypothesis.

His Honour however rejected CAHPL's contention that the implication of SNF was that the hypothetical inquiry required the Court to ignore all attributes and features of the taxpayer (such as membership in a particular industry or status as member of a corporate group).

Robertson J found that if the property (under the Credit Facility agreement) had been acquired under an agreement between independent parties dealing at arm's length with each other, the borrower would have given security and covenants (operational and financial) and, as a result, the interest rate would have been lower. In his view, 'consideration' includes more than just price: it also includes such features as security and covenants that the borrower would have provided to an arm's length lender.

Robertson J held that the correct approach to the inquiry under s136AD(3)(c) required the Court to address an agreement between two parties independent of each other, neither party being an actual party to the actual loan. It was found that the hypothetical exercise should not depart from reality more than is necessary for the hypothesis and it should remain close to the actual loan. His Honour further stated that the statutory hypothesis must include what has been shown on the evidence to be relevant to the market in question. In the present case, the judge held that it must therefore be a factor that the borrower was in the oil and gas exploration and production (E&P) industry.

Whether "independent" should mean "stand-alone"

Robertson J held that s136AAD(3)(d) did not require that CAHPL be considered as a stand-alone company; the provision does not require that the term "independent" be construed as entirely independent of the group rather than just independent of the lender. It was held that for the purposes of the inquiry, the hypothetical independent parties should have the characteristics relevant to the pricing of the loan so as to enable the hypothesis to work. So for example, the hypothetical borrower would also be assumed to be a subsidiary of a major multinational.

Subdivision 815-A – considered in the alternative

Constitutional validity of Subdivision 815-A

CAHPL challenged the constitutional validity of Subdivision 815-A, arguing that ss 815-10 to 815-30 were invalid because they imposed an arbitrary exaction and therefore did not answer the description of a law with respect to taxation for the purposes of s51(ii) of the Constitution.

Robertson J rejected all of CAHPL's arguments in relation to the constitutional validity of Subdivision 815-A and held that the challenge failed.

Preconditions to the making of the Subdivision 815-A 2012 determinations

Robertson J held that Article 9 of the US Double Tax Treaty is a provision relevantly corresponding to Article 9 of the United Kingdom convention. His Honour held that despite different wording in the two Articles, it is sufficient that Article 9 of the United Kingdom convention deals with "associated enterprises" as does Article 9 of the US Double Tax Treaty and that the "gist" of each Article is the same. It was held that therefore, Article 9 of the US Double Tax Treaty answers the definition of an "associated enterprises article" in s815-15(5)(b).

Robertson J also rejected an argument by CAHPL that the Subdivision 815-A determinations were invalid as, in making them, the Commissioner did not make a proper attempt to determine whether CAHPL had obtained a "transfer pricing benefit" or to calculate the amount of that benefit. His Honour held that the argument failed at the evidentiary level and that the mere fact that amounts in the Subdivision 815-A determinations were the same as those in the Division 13 determinations was insufficient to sustain this argument.

Transfer pricing benefit

Robertson J held that the correct approach is to identify the conditions mentioned in Article 9 and then ask if there was an amount of profits which, but for those conditions, might have been expected to accrue to the entity but which has, by reason of those conditions, not so accrued; this involves a comparison of the conditions which operate between CAHPL and CFC in their commercial or financial relations and whether those conditions differ from those conditions which might be expected to operate between independent entities dealing wholly independently with one another. Robertson J rejected CAHPL's submission that, for the purposes of this inquiry, Article 9 permits only an adjustment to the price of a transaction (i.e. the interest rate) and that the Commissioner is not allowed to re-write the terms and conditions of the loan agreement – the Court held that a broader range of conditions are able to be considered. The Commissioner set out some eleven conditions which differed from those which might be expected to operate between independent enterprises dealing wholly independently with one another. These conditions included the terms and conditions of the loan agreement, the duration and currency of the loan and the fact that there were no covenants. Robertson J accepted and took into account the majority of these identified conditions to ultimately conclude that, but for the conditions operating between CAHPL and CFC which differ from those which might be expected to operate between independent parties dealing wholly independently with one another, an amount of profits might be expected to have accrued but did not so accrue; as a consequence CAHPL had failed to show that the assessments were excessive.

The judge also found that it was not necessary for the Commissioner to explicitly state, for each identified condition, precisely how it would differ from the condition which might be expected to have operated between independent enterprises, or how each identified condition was said to have impacted on the pricing of the loan; nor was it a requirement that the "arm's length" conditions be explicitly identified by the Commissioner. His Honour found that it was enough for the Commissioner to identify (as he did in this case) which conditions operate between the two enterprises which differ from those which might be expected to operate between independent enterprises dealing independently with one another.

Pricing & Economic Issues

Currency

Robertson J accepted CAHPL's evidence that the borrowings were denominated in AUD to avoid or limit foreign currency gains and losses to CAHPL. His Honour did not accept the Commissioner's argument that the loan would not have been denominated in AUD if the loan was between independent enterprises dealing wholly independently with one another.

This is not to say that in different factual circumstances, a Court may conclude that the currency of the actual loan differed to the conditions which may be expected to operate between independent parties dealing independently.

As a practical consequence it therefore continues to be important to be able to justify the commercial basis for all terms and conditions of an intercompany loan, including currency.

Implicit Support

Robertson J accepted the Commissioner's submission that there was no legislative warrant for ignoring affiliation between a hypothesised party to a transaction and other members of that party's group of companies (i.e. implicit support may be generally relevant when assessing a borrower's credit rating). Notwithstanding this, on the facts of the present case Robertson J found that the evidence showed that implicit support had very little, if any, impact on pricing by a lender in the real world. The consideration of the relevance of implicit support appears consistent with the new OECD guidance to be inserted into Chapter 1 of the OECD Guidelines (paras 1.164 to 1.167) regarding group synergy benefits in a financial transaction context.

Irrelevance of rating agency practices

Robertson J held that the question of the borrower's credit rating should be considered from the perspective of a lender, and that a commercial lender would not approach this question in the same way as would a credit rating agency. Accordingly the practices of rating agencies were not considered to be relevant.

This approach can be contrasted with the GE Capital Canada transfer pricing case regarding guarantee fees, where the judge also accepted the relevance of implicit credit support, however placed more emphasis, based on the facts of that case, on the impact of such support (some 3 notch upgrade in credit rating). The judge in the GE Capital Canada case also generally supported credit rating agency practices as relevant to determining the arm's length price (for the guarantee fee under consideration).

Other issues

Whether Article 9 confers a separate taxing power

Robertson J found against a long standing view of the Commissioner in holding that Article 9 did not confer a separate taxing power on the Commissioner. His Honour found that the authorities established that the associated enterprises article allocates the taxing power between the treaty parties, or limits the already existing domestic taxing power of one of the treaty parties to avoid potential double taxation, but does not confer any power to assess on the assessing body. The Commissioner was therefore unable to rely on Article 9 independently of the transfer pricing provisions in the domestic legislation.

The decision on this issue is significant in that it contradicts a long held view by the Commissioner that the associated enterprises article of Australia's double tax agreements confers an independent power on the Commissioner to impose tax. As a result of the decision on this issue, Subdivision 815-A has greater importance for the Commissioner] in that the he will no longer be able to rely on Article 9 in the absence of Subdivision 815-A.

Validity of Division 13 determinations

One of CAHPL's key arguments in its primary case was that the Division 13 determinations were invalid or inoperative and therefore could not be relied upon by the Commissioner to support the Division 13 amended assessments. The basis of CAHPL's contention was grounded in the lack of authority of the particular ATO officer who made the determinations in dispute.

The decision on this issue is significant in that it contradicts a long held view by the Commissioner that the associated enterprises article of Australia's double tax agreements confers an independent power on the Commissioner to impose tax.

Robertson J held that the lack of authority of the ATO officer to make the determinations under Division 13 did not mean that the determinations were a nullity. Robertson J followed the WR Carpenter case in finding that the only relevant question is whether the assessments are excessive; the Court will not look behind the assessment making process to test the actual authority or actions of ATO officers.

It was held that “since s177(1) establishes, on the production of a notice of assessment under the hand of an officer there specified, the “due making” of the assessments, a defect of the kind presently under consideration in a determination under s136AD(3)(d) which forms part of the making of the assessments does not demonstrate excessiveness of the assessment”.

Penalties

Robertson J accepted the Commissioner’s submissions as to “scheme benefit”: that is, apart from the scheme, it was reasonable to expect that CAHPL would not deduct the interest under the Credit Facility agreement but instead would have borrowed at an arm’s length interest rate and deducted that lower interest expense; further, that it was reasonable to conclude that CAHPL entered into the Credit Facility Agreement for the dominant purpose of obtaining a “scheme benefit”. Internal emails and communications between staff of CAHPL and the Chevron head office were critical in assisting the Commissioner to persuade the Court to draw this conclusion.

As a result, the Court accepted that penalties of 25% of the scheme shortfall amount could be imposed.

Appeal

Given the complexity of the case and the tax dollars at stake, there seems a high likelihood that CAHPL will appeal.

What should multinationals do now?

Multinationals with intra-group financing arrangements should review their positions against this judgement particularly having regard to the issues of:

- Delineation of the intercompany transaction(s) in the context of the law e.g. review whether the characteristics of the transaction are consistent with the substance and conduct of the parties before selecting and applying the most appropriate transfer pricing methodology
- Implicit credit support e.g., is this an issue that should be considered in the pricing?
- Security e.g., would an arm’s length loan have been secured? It would be relevant to consider other third party financing is in place e.g. senior bank debt
- Currency, and the commercial basis for the choice of currency of intercompany loans
- Strength of the comparables analysis having regard to the actual conditions of the arrangement.

Many of the issues in this case are not confined to financing. The judge’s approach to replace aspects of the intercompany transaction with features that would have happened at arm’s length in the market will have relevance beyond financing. Consider for example a sale of hard-to-value intellectual property, or a license of intellectual property to associates, where for each a key question will be how parties acting at arm’s length would have structured the terms of the transaction. As such, multinationals should consider this and broader ‘reconstruction’ powers under Subdivision 815-B in any transfer pricing analysis.

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