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November 2014

Tax insights

Taxing the Hypothetical: Chevron Australia Holdings Pty Ltd v Commissioner of Taxation

How arm's length is the "arm's length" test under the transfer pricing provisions in Australian tax law? That question has been hotly debated in the Chevron case before the Federal Court over the past few weeks.

The most recent transfer pricing case in Australia has just concluded and has revealed some key insights into the Australian Taxation Office ("ATO") thinking and approach to the enforcement of the transfer pricing rules in Australia. Justice Robertson has reserved his judgment which is expected to be released over the next few months.

The forthcoming judgment should provide useful guidance for transfer pricing practitioners and taxpayers alike, by shedding light on how much of a related party's individual facts and circumstances should be brought to bear in making the objective determination of an arm's length price.

The Court should also provide some more specific guidance on a number of technical issues argued between the parties, including the extent of the applicability of Subdivision 815-A to taxpayers governed by the Australia/US Tax Treaty, the overlap of 815-A and the former Division 13 regime, the validity of certain determinations made by officers of the ATO under Division 13 and the extent to which evidence of a taxpayer's motive is permitted or relevant to a transfer pricing enquiry.

The five week trial between Chevron Australia Holdings Pty Ltd (CAHPL) and the ATO has evolved with argument and cross examination of numerous executives within Chevron (both local and global) and several transfer pricing experts who have been brought in by both the ATO and CAHPL to assist the Court.

At the heart of the case is the transfer pricing implications of an intercompany loan arrangement

between CAHPL and its US subsidiary, ChevronTexaco Funding Corporation (CFC).

CFC was established for the purpose of raising funds in the US commercial paper market and on-lending those funds to CAHPL. Around 2003, CFC lent CAHPL the $A equivalent of $US2.5 billion at an interest rate of AU LIBOR plus 4.14% under a loan agreement with a maturity date of 30 June 2008.

The primary issue in the case is whether the interest paid to CFC by CAHPL in the relevant income tax years (being 2004 to 2008) exceeded an arm's length price for the borrowing. Given the span of years involved, the case involves provisions under both the former Division 13 Income Tax Assessment Act 1936 (ITAA 1936) and Subdivision 815-A ITAA 1997.

This is the first time the Court has considered Subdivision 815-A and it has been more than two years since the transfer pricing provisions were considered in the SNF decision in the Federal Court.

We share our insights into some of the key themes and arguments which emerged before the Court.

'Independent' parties

The critical issue in the hearing was the extent to which the particular attributes of a taxpayer should be considered in the arm's length enquiry.

CAHPL argued that for the purposes of the transfer pricing rules, the Court should approach the application of those rules with a blank canvas, only consider CAHPL as if it was a standalone entity and then apply an "arm's length" price to the relevant transaction, i.e. the loan.

By contrast, the ATO contended that the Court must consider a hypothetical independent party but assume it is clothed with the same characteristics as CAHPL including being part of a group with the same characteristics as the Chevron group and borrowing from a lender with the same characteristics as CFC (i.e. subject to the same policies etc. of the Chevron group). In particular, these characteristics include that a guarantee or implicit support would ordinarily be provided by a parent entity in a corporate group. Although the issue has been previously raised in SNF, the ATO argued that the SNF decision was of only limited guidance as it dealt with a different market context. That is, financing transactions, and the price paid for funds under those transactions, are intrinsically linked to, and cannot be separated from, the particular characteristics of the borrower.

The extent to which those attributes are included has a critical bearing on financing transactions as the credit rating agency reports submitted to the Court gave guidance on the appropriate pricing of the loan.

Relevant expert witnesses were cross examined on their differing opinions on whether CAHPL's credit rating should be notched up by virtue of its parentage and, if so, by how much.

The ATO also heavily cross examined Chevron executives about Chevron's broader financing for the group and how it managed the group's foreign exchange risks. It was revealed in this examination that Chevron Corporation's policy was to minimise borrowing costs and exposure. The ATO argued that it would have been consistent with the group's policy for CAHPL to take advantage of its parent's credit rating to borrow at close to LIBOR, rather than borrowing at a higher rate.

The Court's determination of this issue will have implications for transfer pricing more broadly but particularly concerning intercompany loan arrangements. Taxpayers who have intercompany loan agreements where the price of the loan is or is not impacted by implied parental support may have to reconsider this pricing depending on the outcome of the Chevron proceedings.

Arm's length purpose/substance over form

A continuing theme in the proceedings, including the cross examination by the ATO of Chevron's key witnesses, concerned the extent to which a taxpayer's motive can be considered in dealing with transfer pricing provisions.

CAHPL argued that this cross examination was irrelevant and that both Division 13 and Subdivision 815-A do not consider whether the taxpayer has a non-arm's length purpose and do not permit the Court to consider the substance of an arrangement over its form. CAHPL contended that the sole test is whether the relevant price is arm's length; the ATO cannot use Division 13 or

815-A as a proxy for the general anti-avoidance provisions under Part IVA and these provisions do not permit the ATO to reconstruct or add in terms to the loan or consider a question of substance over form.

The ATO argued that motive is relevant in terms of determining whether independent parties would not have entered into a loan on the terms of the credit facility and that the Court must consider and take into account the conditions that operated between the parties and the non-arm's length circumstances of the loan in making that determination.

The outcome of this issue will have implications as to whether evidence of purpose/ motives behind related party transactions could be used by the ATO when considering arm's length consideration and the applicability of transfer pricing rules.

Treaties and OECD Guidelines

CAHPL contended that Article 9 of the Australia/US tax treaty does not confer on the Commissioner a separate taxing power. CAHPL also challenged whether the Subdivision 815-A provisions, which deal with the application of the Business Profits and Associated Enterprises articles of Double Tax Treaties, can be applied given the specific wording of the Australia/US tax treaty, which applies to the relationship between CAHPL and CFC.

Specifically, CAHPL pointed to s815-10(2) which allows the Commissioner to negate a transfer pricing benefit (i.e. under 815-10) if the entity gets the transfer pricing benefit at a time when an international tax agreement containing an associated enterprises article applies to the entity. The associated enterprises article is defined by reference to Article 9 of the United Kingdom convention or a corresponding provision of another international tax agreement. CAHPL argued that the inclusion of Article 1 (a non-aggravation clause not found in OECD Model Tax Treaties) in the US tax treaty precludes Article 9 of the US tax treaty from being considered a "corresponding" article to Article 9 of the UK treaty.

If the taxpayer's submissions are accepted by the Court, Subdivision 815-A may only have limited application to other taxpayers subject to the Australia/US tax treaty.

In relation to the OECD Guidelines, CAHPL contended that they are merely guidelines and are not legally binding; furthermore they do not permit or justify the Commissioner's attempts to recharacterise the financing transaction

Technical aspects of the legislation

CAHPL has challenged instances where the ATO has issued assessments under both Division 13 and Subdivision 815-A. Subdivision 815-A only operates where transfer pricing arrangements are productive of a transfer pricing benefit. CAHPL has argued that in circumstances where Division 13 operates to determine an arm's length price, there is no transfer pricing benefit to which Subdivision 815-A can then attach.

CAHPL has also questioned the authority of the individual ATO officer who made the Division 13 determinations and therefore the validity of the assessments which relied upon the determinations.

If the ATO's designated officers did not have the relevant authority to make determinations under Division 13, subsequent assessments based on these determinations may not be valid. CAHPL may then be able to argue that Division 13 is not able to apply.

Burden of Proof

Finally, taxpayers have been reminded that in any tax dispute the taxpayer bears the burden of proof. The accounting staff of CAHPL were heavily cross examined on alleged discrepancies in company accounts concerning the actual quantum of the loan. The ATO argued that as a threshold issue the taxpayer needs to prove the actual level of the loan incurred before claiming any deduction for the interest charged.

Suggested Actions

In addition to the implications of the Chevron judgement for international related party loans covered by Division 13 and Subdivision 815-A, additional transfer pricing legislation contained in Subdivision 815-B ITAA 1997 applies to taxpayers with effect from 29 June 2013. Given increasing ATO scrutiny it would be prudent for taxpayers to carefully review and document their intra-group borrowings in light of Subdivisions 815-A and 815-B and carefully consider the implications of the decision in Chevron once this is handed down.

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