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Tax Insights

Reflections on the Chevron debt financing transfer pricing case – a post-BEPS decision?

Snapshot

On 21 April 2017, the Full Federal Court (Full Court) rejected an appeal by the taxpayer involving a credit facility extended to Chevron Australia Holdings Pty Ltd (CAHPL) by a US resident subsidiary of CAHPL. This is the first Australian transfer pricing court case on the issue of related party loans. The case involved approximately $340m in tax and penalties covering the 2004-08 period.

The US subsidiary had borrowed the funds ($2.5b AUD equivalent) externally in USD at an interest rate of around 1.2%, with the benefit of a guarantee from the ultimate parent company, Chevron Corporation (CVX). It then on-lent the funds to CAHPL at an interest rate of 1 month AUD LIBOR + 4.14% (which equated to around 9% in the period under review). This interest rate was based on a stand-alone credit rating of CAHPL and

transfer pricing analysis using the actual terms and conditions of the facility.

The ATO had issued CAHPL with transfer pricing assessments on the basis that the interest rate on the loans was considered to be in excess of an arm's length rate. The assessments were raised under two separate transfer pricing provisions, namely Division 13 of *Income Tax Assessment Act 1936* (ITAA 1936) and Subdivision 815-A of *Income Tax Assessment Act 1997* (ITAA 1997).

In addition to the substantive interest rate issue, the Full Court also considered a number of procedural and legal matters, including:

- Whether the determinations under Division 815-A (which has retrospective effect to income years commencing on or after 30 June 2004) were constitutionally valid, and
- The impact of the fact that the ATO officer who made the assessments was not properly authorised.

The Full Court upheld the earlier decision of Robertson J. 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 failed in proving that the amended assessments imposed by the Commissioner of Taxation (the Commissioner) under Division 13 were excessive. This latter point is important, since under section 14ZZK(b) of the *Taxation Administration Act 1953,* the onus of proof was on CAHPL to prove that the assessments were excessive. As such, the Commissioner was not obliged to argue every technical aspect of his assessments.

In detail

The key points of the judgement are as follows:

- Relevantly in this post-BEPS environment, the judgment affirms the role of the transfer pricing provisions as part of the anti-avoidance arsenal available to the Commissioner. Further, it was held that Division 13 should be applied taking into account the intent of the legislation and real world commercial considerations, and should not be interpreted in a restrictive manner. It is clear that the transfer pricing provisions give the Commissioner broad powers to substitute a more commercially realistic transaction where the actual transaction is considered to be, in whole or part, one that could not occur in the open market.

- From a legal perspective, the defects in the making of the determinations which gave effect to the relevant assessments did not affect the validity of the assessment, and did not assist the taxpayer in seeking to set those assessments aside. The decision reaffirms the critical burden of proof in tax cases which rests with the taxpayer and the Court's willingness to determine matters in a way that is fair, without unduly relying on administrative technicalities.

- The Full Court confirmed the decision of the trial judge, Robertson J., in holding that the arm's length inquiry retains the context and reality of a multinational group and found that there was no reason to depart from the trial judge's view that an independent borrower like CAHPL, dealing at arm's length, could have given security and operational and financial covenants to acquire the loan, which would have resulted in a lower

interest rate. This is particularly relevant for situations where no senior secured debt is in place in addition to related party debt arrangements.

- Consideration should be given to the availability of an explicit parental guarantee being obtained by the borrower in a related party financing transaction. Where such a guarantee may be available, the interest rate would be expected to be lower; and if not available, the taxpayer should be in a position to explain why not. Technically, the case was not decided on this issue, but Allsop CJ. pointed out that even if CAHPL was unable to pledge security or agree to any financial and/or operational covenants, it would be of "no relevant consequence" if there was a reasonable expectation that Chevron (or a company in Chevron's position) would provide a guarantee. Similarly, Pagone J. thought there was force behind the argument that CAHPL, in a hypothetical arm's length transaction, might have paid a guarantee fee to its parent, which his Honour reasoned could still form part of the "consideration" paid by CAHPL, despite being paid to a third party to the loan (i.e., CVX). Ultimately, Pagone J. determined there was insufficient evidence that such a fee would be part of the consideration paid by CAHPL in respect of a hypothetical loan. It is therefore possible in future cases that courts may be persuaded by parental guarantee arguments advanced by either taxpayers or the Commissioner.

- In the Full Court decision, there was no guidance on the issue of passive affiliation (i.e. the concept that a third party lender would take into account the wider group affiliation when assessing the creditworthiness of a subsidiary, and where no explicit guarantee is provided). The decision at first instance was not dismissive of the concept of parental affiliation. However, in that decision, 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."

- Accordingly, the Full Court decision will have significant implications in applying the transfer pricing provisions in financing transactions. In such an environment, the specific profile of the borrower and the available support from its corporate parent or other related entity is critical in the determination of the arm's length cost of finance. However, given the importance of the facts in this case it is unclear what, if any, the implications of this decision may be in different transaction types (e.g., tangible goods or intangibles transactions).

- Justice Pagone saw no reason to depart from the conclusion of Robertson J. that the hypothetical agreement might reasonably have been expected to be in Australian currency.

- In summary, the Full Court rejected an approach to transfer pricing which involved working out accurate pricing for the transaction which actually occurred. Instead, it suggested that the law allowed the Commissioner to substitute a transaction which reflected how a company in the taxpayer's position would achieve the same commercial aims in an arm's length transaction. Accordingly, evidence about the taxpayer's usual commercial practices (or lack of such evidence) was central to key parts of the decision.

Impact

The decision will no doubt embolden the ATO, particularly in respect of the other financing audit cases which are currently underway, in targeting new cases for audit. Senior ATO leadership have described intra-group financing as the number one risk it is focused on with regard to multinational taxation.

Whilst this decision is predominantly a Division 13 related one, it is arguably consistent with the outcome that might be reached under Australia's new transfer pricing laws, Subdivision 815-B (for income years after 30 June 2013), which contains what are referred to as the 'reconstruction powers' (section 815-130), are explicitly linked to the OECD Guidelines. While the Full Court was unclear on the extent that Division 13 allowed for reconstruction of the actual terms and conditions of the loan, it nonetheless reached the view that CAHPL, if it had been acting independently and dealing with a third party lender, would have been expected to have given security and operational and financial covenants to acquire the loan. The Full Court adopted this approach by relying on the evidence of two expert witnesses, ironically provided by Chevron, who testified that a loan of a comparable size in the oil and gas sector would not have been made by an independent lender in the absence of such requirements. The appropriate security and covenants would also have served to reduce the interest rate applied to a comparable loan by an independent lender.

Within the constraints of Division 13 (which are narrower than the current transfer pricing rules in Subdivision 815-B), the "reconstruction" of certain terms in the facility agreement was considered to be appropriate on the basis of the Full Court's view that security, covenants and a parental guarantee form part of the "consideration" provided for acquiring the "property" (being the credit facility in this case).

This type of commerciality overlay and mindset applied by the Full Court is consistent with the current OECD view in the BEPS project, and as such, notwithstanding that the arrangement related to the 2004-08 period, and was argued under former laws, this decision could be considered a post BEPS decision, and may be indicative of how future courts may consider financing where the OECD Guidelines have relevance to local transfer pricing legislation. That is, the arm's length principle is more than the simple pricing of a given transaction (given the actual terms and conditions), but rather also encompasses the question of whether an independent party, acting in its own best interests, would have entered into a transaction on those terms and conditions. In fact, Allsop CJ. noted that it could be accepted without difficulty that an unsecured loan issued by a stand-alone company in CAHPL's position with no operational or financial covenants would have an interest rate above 9%.

A critical component of the Full Court's conclusion was that a subsidiary, from a pricing perspective, should not be viewed as an 'orphan' from the multinational group. That is, it should be viewed as it is, as part of a larger group and having its credit characteristics potentially influenced by its association with that larger group. This is consistent with the new OECD Guidance in Chapter 1 of the BEPS Actions 8-10 report. As noted above, the decision at first instance did not consider in this case that implicit support would have a material impact on pricing. It is unclear how much this non-orphan view will impact on the pricing of related party dealings other than financing, e.g. the pricing of goods or services. Further, we note that in the application of the 'arm's length debt test' in Australia's Thin Capitalisation provisions (Division 820), the legislation specifically requires that all connections of the Australian taxpayer with the multinational group be ignored. It seems that this approach provides the worst possible

combination for taxpayers regarding their allowable debt deductions, with the arm's length *amount* of debt (above the thin capitalisation 'safe harbour') set without reference to the wider group, but the arm's length *price* of the debt required to be set with regard to the wider group. This appears to be a possible inconsistency in policy rationale which will need to be monitored.

The original decision at first instance contained adverse comments on the use of credit ratings to ascertain the interest rates on loans and indeed in that case Robertson J. dismissed the many expert witnesses that were called before him. This may be attributed to the fact that Robertson J. did not consider the transaction priced by the experts to be commercial in the first place. The Full Court on appeal did not discuss these issues and did not seek to compute an appropriate arm's length rate of interest for the loan, other than to say that the taxpayer had not discharged its burden of proof that the Commissioner's assessments were excessive. Accordingly, in our view there is still some uncertainty on the practicalities of pricing related party loans, in the absence of a fully comparable pricing analysis undertaken by an independent lender.

The importance of internal agreements and group policies is also highlighted in this case. The rights and obligations conferred in the credit facility agreement, the Chevron group's internal policies and its decision making processes regarding financing arrangements were taken into account by the Full Court in reaching its decision as to an arm's length arrangement that might have been entered into by CAHPL.

Action

The decision provides the first substantive judicial guidance in Australia on the difficult territory of establishing arm's length financing arrangements between related parties. It gives taxpayers much to consider and apply in evaluating their own arrangements.

Specifically, the lesson to be learned for taxpayers which have, or are contemplating, intra-group financing arrangements is the need to demonstrate the commercial context of the intercompany arrangement, including bringing forth evidence supporting this. This review may cover areas such as:

- Existing group policies on financing and parental security
- The role of subsidiary companies in the group structure
- Alternative related party arrangements which were considered (and reasons for rejection, if appropriate), and
- Other evidence which supports the commerciality of the pricing of the taxpayer's arrangement.

Consequently, we would recommend that taxpayers review both their historic and prospective related party financing arrangements in light of this decision. This would include a review of all intercompany arrangements and legal agreements and all background information and documentation that will assist the consideration of how best to defend the position in the event of an ATO review, and consideration of any requirements to restructure their arrangements, or seek certainty from the ATO via an Advance Pricing Arrangement.

Given the quantum of tax involved and the importance of the issue for their other related party loans, it is possible that CAHPL will seek special leave to appeal to the High Court. Affected taxpayers should therefore monitor the outcome of any potential High Court appeal in the coming months.

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