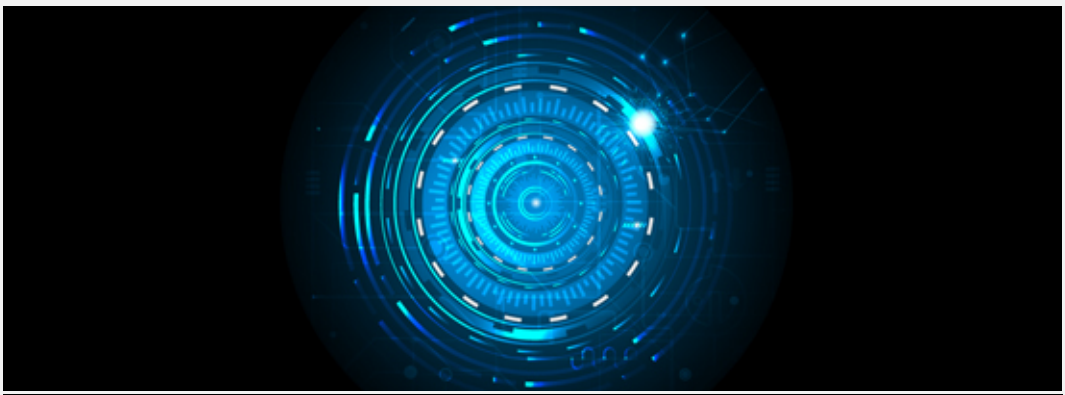

Australia issues guidance on transfer pricing and financing arrangements

Global Transfer Pricing Alert 2018-031

The Australian Taxation Office (ATO) on 31 October released draft Taxation Determination TD 2018/D6, which deals with the interaction of the transfer pricing rules in Subdivision 815-B and the debt/equity rules in Division 974 of the Income Tax Assessment Act (ITAA) 1997. The previous TD that dealt with the interaction of the rules in Division 974 and the now repealed transfer pricing rules in Division 13 ITAA 1936 (TD 2008/20) was withdrawn on the same day.

Division 974 characterizes an arrangement as either a debt interest (on which returns generally are treated as assessable/deductible interest) or an equity interest (on which returns generally are treated as dividends) for tax purposes.

Draft TD 2018/D6 follows the same general line that was taken in TD 2008/20 and states that the transfer pricing rules will prevail over the rules in Division 974. The draft TD asks the question: Can the debt and equity rules in Division 974 of the Income Tax Assessment Act 1997 limit the operation of the transfer pricing rules in Subdivision 815-B of the Income Tax Assessment Act 1997? The ATO's answer to this question is "no."

The ATO's position is based on the fact that Subdivision 815-B explicitly states that nothing in the income tax legislation limits the operation of the transfer pricing rules. In other words, the application of the prescriptive rules in Division 974 to characterize a financing arrangement as either debt or equity for tax purposes is not necessarily the end of the matter. If the commissioner takes the view, under Subdivision 815-B, that the arrangement would have been different under arm's length conditions, then "Division 974 applies to classify the interest

that arises under the scheme by reference to the arm's length conditions, not to the actual conditions."

It is important to note that Subdivision 815-B does not apply in all cases in which there are differences between the actual conditions and arm's length conditions, as the subdivision is applied only when a transfer pricing benefit, as defined, arises. Therefore, there may be instances in which Division 974 will be applied to the actual conditions, even when the arm's length conditions may be different.

Helpfully, the draft TD provides three examples that cover both inbound and outbound financing arrangements. Most pleasingly for taxpayers, example 3 describes a situation whereby an outbound interest-free loan (treated as debt under Division 974) will be treated as an equity arrangement (for transfer pricing purposes). As a result, under the transfer pricing provisions the Australian lender would not be deemed to have derived interest income. This broadly follows the approach taken in Taxation Ruling TR 92/11 (dealing with the ATO's approach under the former Division 13 ITAA 1936) whereby certain intercompany financing arrangements could be treated as "quasi-equity" and therefore not considered by the commissioner to accrue notional interest amounts. This will be especially welcome news for the energy and resources sector, where outbound arrangements such as this are common and where there has been some uncertainty since the repeal of Division 13 about how the ATO will treat these situations.

There is more to come on this front, with the ATO expected to release shortly draft schedule 3 to PCG 2017/4, which will set out principles for determining whether interest-free loans made between related parties should be characterized as either debt or equity in identifying the arm's length conditions for transfer pricing purposes.

Example 1 illustrates an outbound arrangement to a distressed subsidiary that is classified by Division 974 as equity (with the returns to Australia therefore non-assessable non-exempt income), and where the application of Subdivision 815-B substitutes the actual conditions with arm's length conditions. On that basis, the draft treats the arrangement as an interest-bearing loan, therefore enabling the commissioner to use the transfer pricing provisions to deem assessable interest income to the Australian lender.

Example 2 involves a 15-year inbound arrangement where there is a discretionary interest clause. Under Division 974, this would be characterized as equity based on the actual conditions; however, the example shows the outcome when the commissioner determines that the arrangement would be debt under arm's length conditions. The focus on example 2 is on the withholding tax that would be payable on interest under the debt treatment -- a reminder that reduced interest or royalty withholding tax is a transfer pricing benefit under the definition in s 815-120.

Unfortunately, there appear to be some drafting errors in the draft TD. Some aspects of the draft TD require further clarification, and the examples also raise additional questions.

In example 2, where the transfer pricing conclusion is based on interest paid from Australia to a nonresident, the draft TD flags

that the commissioner may exercise his/her discretion and make a consequential adjustment to allow the Australian company a deduction for the interest amount. Unfortunately, the draft does not shed any light on how the commissioner will go about exercising his/her discretion in respect of such a consequential adjustment;

Another area that would be useful to clarify is the process the ATO will use to consider the arm's length conditions, and how these will be established and then applied. The draft currently says that the arm's length conditions assumed in the examples should not be taken as ruling on what the arm's length conditions would be. Examples 1 and 3 both involve outbound financing to wholly owned foreign subsidiaries that likely could not borrow in external debt markets; the draft concludes that the arm's length conditions in example 1 result in the arrangement being treated as an interest-bearing loan, whereas the arm's length conditions in example 3 result in the arrangement being treated as equity.

Taxpayers may wish to take the opportunity to review the terms of their cross-border financing arrangements in light of the draft TD. This will be especially important for arrangements that have features of both debt and equity, as the ATO could take a different view and seek to alter the arrangement's characterization and thus the tax treatment of the return on the arrangement.

Deloitte Australia will be making a submission to the ATO on draft TD 2018/D6, and welcomes any feedback from taxpayers who would like to contribute to this response.

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