The wrestle between transfer pricing and other provisions continues: this time transfer pricing takes on the debt/equity rules in relation to cross-border debt financing

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In brief

The Australian Taxation Office (ATO) has released a draft Taxation Determination, TD 2018/D6, which outlines the Commissioner's view that the debt and equity tax rules do not limit the operation of Australia's transfer pricing rules.

Although this draft Determination is the latest in a series of draft guidance issued by the ATO this year regarding cross-border debt financing (refer to this TaxTalk Alert for a summary of recent ATO issued guidance), a number of key interpretative issues relating to the practical application of the transfer pricing rules have not been addressed and there are a range of collateral issues flowing from the position taken by this latest Determination which also remain unaddressed.

In detail

TD 2018/D6, issued on 31 October 2018 for comment, sets out the Commissioner's view that the transfer pricing rules in Subdivision 815-B of the *Income Tax Assessment Act 1997* effectively "trump" the debt/equity provisions in Division 974. This position is predicated on the wording in subsection 815-110(1) which the Commissioner has interpreted as indicating that Subdivision 815-B overrides all other provisions of the tax laws, including the debt/equity rules in Division 974.

The Commissioner states that where section 815-115 applies to a scheme that is a "financing arrangement", the "arm's length conditions" are taken to operate for the purposes of working out the amount of the entity's taxable income, taxable loss of a particular sort, tax offsets and withholding tax payable. The ATO considers that in these cases, the arm's length conditions (which is a concept in the transfer pricing rules) should be identified and Division 974 applied to classify the interest that arises by reference to the arm's length conditions rather than the actual conditions. The Commissioner has rejected an alternative interpretation which, arguably, would better sustain the original policy intent of the debt/equity rules.

The draft Determination includes three examples:

1. Outbound loan to a distressed subsidiary

2. Inbound discretionary interest loan

3. Outbound interest-free loan

All three examples consider legal form loans. In both Examples 1 and 2, the relevant scheme would prima facie satisfy the equity test but, based on arm's length conditions as substituted by section 815-115, would instead satisfy the debt test.

Example 3 envisages a scenario where arm's length conditions are identified on the basis of commercial or financial relations that involve a contribution of equity rather than a loan and that the arm's length conditions would satisfy the equity test (the draft Determination does not state that the debt test is failed but this seems to be the implication). Example 3 continues to say that as there is no transfer pricing benefit, Subdivision 815-B does not operate and the classification of the arrangement as a debt interest is not affected. Example 3 is the only example which contemplates the transfer pricing rules reconstructing the legal form of an actual arrangement.

This draft Determination has long been anticipated since consultation on the interaction between the debt/equity rules, transfer pricing and the dividend participation exemption (Subdivision 768-A) back in early 2015. However, the draft may be viewed as raising more questions than answers because a number of key outstanding issues have not been addressed by the ATO. Understanding what this draft Determination really means for taxpayers will require detailed consideration and we foresee that a number of unexpected flow-on consequences will emerge.

The issues alluded to in the draft Determination which are specific to interest free loans may also need to be further considered when the ATO releases Schedule 3 to PCG 2017/4 which deals with cross-border related party financing arrangements and transactions and which will *"set out factors for determining whether an interest-free loan between related parties could be either debt or equity in identifying the arm's length conditions"* (based on the ATO's Advice under Development webpage).

(a) Identifying arm's length conditions

Identifying the relevant arm's length conditions with respect to financing arrangements underpins the analysis as to whether the debt/equity characterisation of an instrument may be impacted due to the operation of Subdivision 815-B. However, the draft Determination does not provide guidance on how to identify what the relevant arm's length conditions are or what the key considerations might be in the context of these particular examples. TR 2014/16 provides the ATO's general views about the relevance of the actual commercial or financial relations to the identification of the arm's length conditions.

In the absence of guidance, taxpayers and advisers can only assume that the identification of comparables, and the associated analysis of those comparables, will be key going forward. Further, given the retrospective nature of the determination, it may also be required for positions that have been taken previously - including potentially where the relevant instrument is no longer on foot and the income years remain open for assessment.

This will be a challenge in practice, particularly given the breadth of commercial financial instruments seen in the market, such as perpetual notes, interest free loans, convertible notes, discounted notes, turnover based instruments, zero coupon bonds, profit participating loans and preference shares, as well as the non-tax reasons certain instruments have been put in place to deal with issues such as foreign exchange, accounting, treasury and foreign regulatory, legal and tax requirements - which are all factors to consider when assessing if "reconstruction" should (or even can) apply.

In the current environment, it is especially important for taxpayers to understand the financing options available, the commercial reasons for entering into different types of arrangements and how these align with the taxpayer's capital structure. It is necessary to consider this from both the lender and borrower's perspective. For instruments where the debt/equity analysis turns on very specific terms, it may be necessary to undertake additional transfer pricing analysis to confirm the application of Subdivision 815-B.

(b) The elephant in the room - reconstructing commercial and financial relations?

The tax law requires that arm's length conditions be identified based on the actual commercial or financial relations, except where the commercial and financial relations should effectively be "reconstructed" or disregarded (section 815-130). This reconstruction is different to the substitution of arm's length conditions. The potential for reconstruction is alluded to in Example 3, which seems to suggest that a legal form interest-free loan to a wholly-owned foreign subsidiary in the exploration stage of a mining business that could not obtain debt finance, could be reconstructed to "equity" by "having regard to section 815-130".

The Chevron case (*Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation [2017] FCAFC 62*) provided us with the first view of the Australian Courts in relation to the operation of the transfer pricing provisions in a related party financing context. Reconstruction was perhaps set to be the key aspect of the case. However, the Court was able to reach its judgement more conveniently through a lack of persuasive evidence to disprove the excessive nature of the Commissioner's assessment. This has left us in a state of flux in relation to the threshold question of when and how a Court would look to respect the actual terms of a transaction and when the reconstruction provisions would be enlivened.

In the Chevron case, the Court respected the currency of the loan as well as the arrangement having different terms to the commercial paper that the parent issued to fund the loan. While the judgement was primarily focused on former transfer pricing rules (Division 13), it has created some ambiguity in relation to the distinction between "commercial or financial relations" and "conditions", as relevant to current Subdivision 815-B. This is as a result of the broad manner in which the Court appeared to define the concept of "conditions" under a different statutory construct to Subdivision 815-B.

As the ATO outlines in TR 2014/6, the reconstruction provisions in subsection 815-130 apply to reconstruct the commercial or financial relations, not the arm's length conditions. As it is only the arm's length conditions which are taken to apply for all purposes of the tax law (and not the reconstructed commercial or financial relations) the distinction between the two concepts becomes very relevant in understanding the practical implication of this draft Determination.

This now leaves us with an interesting question in a financing context. Can something be both a commercial or financial relation and a condition? Or should the two be mutually exclusive? In Chevron, the ATO submitted that there were some 11 conditions that were not arm's length. Many of these arguably, if asked in the context of Subdivision 815-B, may have been couched in the context of "there were 11 or so aspects to the commercial or financial relations" that may not be arm's length. Unfortunately we will never know whether the Court would have drawn such a distinction.

The point of all of this is that the draft Determination fails to address the fulcrum of the reconstruction powers of Subdivision 815-B. It simply jumps to the conclusion that if something is reconstructed, then that reconstructed arrangement is the basis for applying the test in Division 974.

Where conditions include the commercial or financial relations, then this point of debate becomes moot; the outcome is the same in all instances. The commercial or financial relations would be reconstructed to equate to the conditions and the conditions are the same as the commercial or financial relations; so who cares how they are defined.

However, if you agree to define the commercial or financial relations as being nothing more than a debtor-creditor relationship, then the implication for Division 974 becomes interesting. If transfer pricing would make a legal form loan a legal form share, do the conditions that are then reconstructed include the dividend, voting and capital rights on the "reconstructed" share? If so, would these components impact the Division 974 characteristics? Are the conditions limited to just the "price, rate or profit margin"? If so, and therefore we only import a different "rate" under Subdivision 815-B, will it only be in very rare circumstances that the outcome under Division 974 would change?

Again, the draft Determination does not provide guidance on when or why it may be appropriate to reconstruct the commercial and financial relations. Example 3 merely indicates that the commercial or financial relations would involve a contribution of equity (compared with a loan) without any elaboration

on the basis on which the ATO considers Subdivision 815-B (specifically section 815-130) would operate in this manner.

In Example 2, it is interesting that the substituted arm's length conditions would give rise to a "loan with interest on the outstanding principal accruing periodically and an obligation to pay all outstanding accrued interest at the end of the loan term" rather than, for example, reconstruction to a profit participating loan or legal form ordinary shares or redeemable preference shares.

(c) At-call loans

The draft Determination does not include an example involving at-call loans. The potential for at-call loans to be recharacterised (for example, from an equity interest to a debt interest) is expected to significantly impact a number of taxpayers and raise a number of corollary issues briefly noted below.

For example, interest received on outbound at-call loans may have previously been treated as non-assessable non-exempt income where the instrument is characterised as an equity interest but, if the instrument is recharacterised, could any distribution instead be treated as assessable returns on a debt instrument applying Subdivision 815-B. Conversely, previously non-deductible interest paid on an inbound at-call loan could become deductible if Subdivision 815-B applied to alter the relevant terms and conditions.

There are a range of collateral issues to consider also. For example, does the treatment of foreign exchange gains and losses change (i.e. how do taxpayers determine the instruments nexus with income - what circumstances are relevant to this analysis), what impact will there be on thin capitalisation calculations, taxation of financial arrangement (TOFA) outcomes, tax consolidation, commercial debt forgiveness, conduit foreign income, debt forgiveness, participation exemptions? If the view set out in the draft Determination is correct, all of these collateral issues, and more, will need to be addressed by taxpayers.

(d) Inbound interest-free or discretionary interest loans

The recharacterisation of inbound interest-free or discretionary interest loans from a debt interest to an equity interest is also expected to impact a number of taxpayers, as well as raising various collateral issues.

In Example 2, the Commissioner states that based on arm's length conditions, a loan would give rise to a debt interest and on this basis, interest withholding tax that would have been payable constitutes a transfer pricing benefit. The Draft Determination further states:

> ...the Commissioner **may** make a determination to adjust Australian Company's taxable income or loss, provided the relevant conditions are satisfied.

This deceptively simple excerpt leaves many questions unanswered and raises further issues. Some brief observations and areas where clarification would be useful are:

- Section 815-145 states that the Commissioner may make a compensating adjustment if arm's length conditions are substituted and it is "fair and reasonable" for an amount to be adjusted (broadly speaking). It seems to us that the Commissioner would be required to make a determination to provide the Australian borrower with an income tax deduction because this would be the only "fair and reasonable" outcome. This is consistent with the approach taken under Division 13 in TR 2007/1.

- What would be the implications under the hybrid mismatch rules if a deduction is in effect provided by the transfer pricing rules? Presumably Subdivision 815-B would also override any potential hybrid mismatch which may otherwise be denied (given the primacy afforded to Subdivision 815-B under the draft Determination) or could this be a relevant factor to consider in making a "fair and reasonable" adjustment to the profits of the Australian borrower?

- When would the interest withholding tax be payable? This could depend on a more detailed understanding of the arm's length conditions - when is the interest paid, or if unpaid is it capitalised, and finally, when is the interest income derived?

(e) Potential relief?

In addition to the issues flagged above, other key aspects which we think come into sharper focus include:

- Section 815-140 requires that the interest rate (based on arm's length conditions) must be applied to the "debt interest actually issued". Therefore, it would seem to be the case that Subdivision 815-B does not operate to "trump" section 815-140 by, for example, in the case of an inbound loan, identifying arm's length conditions on the basis of commercial or financial relations that involve a contribution of equity as such a recharacterisation would not seem to give due weight to the statutory text of section 815-140.

- The use by taxpayers to seek relief through a Mutual Agreement Procedure where the ATO approach under Subdivision 815-B and Division 974 leads to double taxation.

(f) Start date

The final Determination is proposed to have retrospective effect, applying to income years commencing on or after 29 June 2013. We note that there is a seven-year statute of limitation for Subdivision 815-B amended assessments. We query the reasonableness of the Determination having retrospective effect, particularly given that this guidance has been anticipated for some time.

TD 2008/20, relating to the interaction between the debt/equity rules and the former Division 13 transfer pricing rules, was also withdrawn with effect from 31 October 2018. In this withdrawn Determination, the Commissioner provided an example where an outbound profit participating loan (tax equity for Division 974 purposes) would have arm's length conditions involving regular interest payments throughout the life of the loan. There was no suggestion in that Determination that the arm's length conditions should be applied for the purposes of Division 974.

The takeaway

The ATO is continuing its unrelenting focus on various aspects of cross-border debt financing and related transactions with this latest draft Determination. Much-awaited guidance is still expected in relation to interest-free loans (to be issued as a draft Schedule to PCG 2017/4), various issues relating to thin capitalisation (including the ATO's compliance approach), the arm's length debt test, and the Decision Impact Statement in relation to the Chevron case.

We are also waiting to see if the Organisation for Economic Cooperation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project can reach consensus regarding its unfinished business in relation to financial transactions. A draft paper was released in July 2018 and further guidance has been promised for 2019.

The application of the transfer pricing rules to financing arrangements has never been more important, impacting not only pricing of debt arrangements but also the fundamental characterisation of arrangements as giving rise to debt or equity. The interaction between the transfer pricing rules and other aspects of the income tax law is complex and raises a myriad of issues that need to be worked through.

Let's talk

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