Corporate Tax Update

2 November 2015

Federal Court of Australia rules on transfer pricing case: Chevron Australia Holdings Pty Ltd v Commissioner of Taxation

On 23 October 2015, in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4)* [2015] FCA 1092, the Federal Court, at first instance, dismissed the taxpayer's appeal against the Commissioner's deemed objection decisions (disallowing the taxpayer's objections) in relation to amended income tax assessments and administrative penalty assessments issued to the taxpayer in respect of each of the 2004 – 2008 financial year. Fundamentally, the dispute centred on the application by the Commissioner of provisions in the income tax law often described as the 'transfer pricing rules'.

In this case, the Commissioner applied the transfer pricing rules in Division 13 of the *Income Tax Assessment Act 1936* (ITAA 1936) in respect of each of the 2004 – 2008 financial year, and Subdivision 815-A of the *Income Tax Assessment Act 1997* (ITAA 1997) in respect of each of the 2006 – 2008 financial year. Under the amended assessments, the Commissioner disallowed deductions claimed by the taxpayer in respect of interest incurred on loans provided to the taxpayer by a related company resident in the United States (USA).
The amended assessments were issued to the taxpayer based on the Commissioner's view that the interest rate applying to the loan exceeded the arm's length rate, and thus the deductions claimed were excessive.

The Court handed down a decision in favour of the Commissioner. The Judge found that the taxpayer did not satisfy the onus of proving that the Commissioner's assessments were excessive.

The Court held that the requirement that there be arm's length consideration requires that you look at the total consideration provided by the taxpayer under the cross-border loan agreement, which includes not just the promise to repay principal and interest, but also other consideration such as financial covenants, security and guarantees.

This analysis enabled the Court to look beyond the simple pricing of the interest payable on the loan based on its actual terms and conditions, and to have regard to whether those other terms and conditions were consistent with what the Court considered an independent party in comparable circumstances would have agreed to.

The Court decided that the consideration provided was inconsistent with what would have been agreed between independent parties. Specifically, the Judge concluded that an independent borrower would have included security and operational and financial covenants in the loan terms, which would have resulted in a lower interest rate, although his Honour accepted that the currency of the loan was Australian dollars.

The Judge did not consider the hypothesising of all the terms and conditions that make up the arm's length consideration to be a 'reconstruction' or 'recharacterisation' of the transaction. The hypothesising of arm's length terms and conditions has implications not only for the pricing of debt transactions, but also for other transfer pricing arrangements where the Commissioner may form a view that the terms are uncommercial, or do not include terms that may be found in arm's length transactions.

The Court accepted the Constitutional validity of Subdivision 815-A, and that the Commissioner can make determinations in the alternative under both Division 13 and Subdivision 815-A (where both potentially apply). The Court did not, however, accept that Article 9 of the Australia-US treaty itself provided a taxing power. The Court also concluded that penalties of 25 per cent of the tax shortfall should apply.

Although the decision was based on the old transfer pricing law in Division 13 and Subdivision 815-A, it will be interesting to see how Australian Taxation Office (ATO) will approach the principles from the case in interpreting the new transfer pricing law in Subdivision 815-B of the ITAA 1997.

The impact of the Chevron court case will be dependent on each taxpayer's specific facts and circumstances.

Taxpayers should contact their transfer pricing advisor for further discussion.

Australian Taxation Office's view on meaning of lodgment day of subsidiary member of consolidated group for Division 7A

Under Division 7A of the *Income Tax Assessment Act 1936 (ITAA 1936)*, a loan or other benefit provided to a shareholder of a private company (or to the associates of the shareholder) may in certain circumstances be treated as an assessable deemed dividend.

However, in the case of a loan, if such loan is fully repaid before the 'lodgment day' in respect of the tax return of the company for the tax year in which the loan is made, or is put on 'commercial terms' (as prescribed in Division 7A) before that day, this assessing provision cannot apply.

Under the definition in subsection 109D(6) of the ITAA 1936, the lodgment day is the earlier of the due date for lodgment of the private company's tax return for the year in which the loan was made and the actual date of lodgment of that return.

In the case of a private company that is a 'subsidiary member' of a tax 'consolidated group', this definition poses some difficulties since, where the company is a subsidiary member of the group for the whole of the tax year, it is the 'head company' which is required to lodge an income tax return, the subsidiary member simply being treated as part of the head company (and not as a separate entity) for the purpose of paying income tax – and lodging tax returns. The effect of this is that on a literal interpretation, the subsidiary member cannot have a lodgment day.

However, in Taxation Determination TD 2015/18, issued on 7 October 2015, the Commissioner rules that "the lodgment day for a private company that is a subsidiary member of a consolidated group, for the purposes of subsection 109D(6) of Part III of Division 7A of the *Income Tax Assessment Act 1936* (ITAA 1936), will be taken to be the lodgment day of the head company of the consolidated group". The effect of this Determination, which applies to income years commencing both before and after its issue, is that the Commissioner's view can be relied upon by the recipient of a loan from a private company that is a subsidiary member of a tax consolidated group in determining whether the loan has been repaid or put on commercial terms before the 'lodgment day' so as to avoid the implication of the loan being treated as an assessable deemed dividend.

If you have any queries in relation to this matter or any matters relating to the operation of the deemed dividend rules in Division 7A, contact Kel Fitzalan on +61 (2) 8266 1600 or at kel.fitzalan@au.pwc.com.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Tom Seymour, Managing Partner
+61 (7) 3257 8623
tom.seymour@au.pwc.com

Adam Davis, Melbourne
+61 (3) 8603 3022
adam.davis@au.pwc.com

Warren Dick, Sydney
+61 (2) 8266 2935
warren.dick@au.pwc.com

Murray Evans, Newcastle
+61 (2) 4925 1139
murray.evans@au.pwc.com

Alistair Hutson, Adelaide
+61 (8) 8218 7467
alistair.hutson@au.pwc.com

David Ireland, Sydney
+61 (2) 8266 2883
david.ireland@au.pwc.com

Anthony Klein, Melbourne
+61 (3) 8603 6829
anthony.klein@au.pwc.com

David Lewis, Perth
+61 (8) 9238 3336
david.r.lewis@au.pwc.com

Julian Myers, Brisbane
+61 (7) 3257 8722
julian.myers@au.pwc.com