Lessons from *Chevron*

In one of the most significant decisions for many years, the Full Federal Court has handed down its decision in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62 unanimously affirming the ATO's amended assessments, which denied the taxpayer deductions for some of the interest expense paid to its US subsidiary. In doing so, some of the reasoning of Pagone J (with whom Perram J agreed) and the separate judgment of Allsop CJ take a different approach to that of the trial judge, Robertson J. The most significant difference is the greater emphasis placed by the Full Federal Court on the taxpayer's place in the worldwide Chevron group and the level and type of support, at least in this case, that has to be assumed (e.g. by way of parental guarantees) when trying to estimate 'arm's length' transfer prices. This Tax Brief focuses on what the litigation (so far) tells us about managing the transfer pricing risks involved in intra-group financing.

1. Background

The litigation revolved around draw-downs under a Credit Facility Agreement entered into on 6 June 2003 between Chevron Texaco Funding Corporation (CFC, a US company) and the taxpayer, Chevron Australia Holdings Pty Ltd (CAHPL, CFC’s parent and an Australian resident, owned ultimately by Chevron Corporation (CVX or Chevron)). The funds were used to refinance external AUD-denominated debt that had been taken on to fund CAHPL’s acquisition of various operating entities.

The facility was for the ‘AUD equivalent’ of USD 2.5bn. The interest rate was set at 1-month AUD LIBOR + 4.14% (approximately equivalent to 9%). Payments were interest-only, payable monthly in arrears. The facility was for a term of 5 years with an option for early repayment by the borrower without penalty, and it could be terminated at any time by the lender. The facility was unsecured; there was no guarantee of performance given by any Chevron entities; there were no operational covenants and no financial ratio covenants.

CFC had borrowed the funds it advanced to its parent in USD in US financial markets at various rates (approximately 1.2%). After paying its own interest expense, CFC made sizeable profits and paid substantial dividends to CAHPL which were not taxable to CAHPL because of s. 23AJ.

Australia’s transfer pricing law was in a state of flux in the years when the facility was on foot (2003-08), although that was not apparent at the time. In 2012, Parliament enacted the Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No. 1) 2012 which added a new (and temporary) Div 815-A into the income tax legislation. The new Division was back-dated to start from 1 July 2004, while the old transfer pricing provisions in Div 13 were not repealed until June 2013 when the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013 was passed.

So not only was the new law back-dated, it also duplicated the existing law from 2004 until 2013. The ATO decided to challenge the interest deductions under both the old law and the new law:
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2. Strictness v. flexibility in handling transfer pricing law and cases

It is striking that the judgment of Allsop CJ in the Full Federal Court begins with a short homily on judging; an introduction that acknowledges the Court’s role as limited to statutory interpretation, but then emphasises the need to be flexible. This essay unwittingly acknowledges from the outset just how uneasily transfer pricing lore sits with our legal traditions.

Allsop CJ says the Court must not, ‘put to one side or ... diminish the necessity to begin and end with the words of the statute [nor] seek to find a purpose of the Division outside its words...’ In the same vein, Pagone J says the application of Div 13, ‘requires application of its actual terms rather than what might have been an unexpressed intention ...’

But Allsop CJ also says, Courts must avoid ‘narrow textualism’ and ‘the words used by Parliament ... should ... be given meaning and operation ... with the necessary flexibility of analysis... The provisions should not be interpreted pedantically.’ He cautions against, ‘beguilingly simple and attractive logic with words driving meaning to unrealistic and impractical ends ...’ Similarly his Honour says, the fiction that underlies transfer pricing (pretend that the parties were not related and were dealing at arm’s length) ‘must be made to work’ even in cases where, ‘the agreement in question is not easily commercially replicated or posited in the real world...’

Just what one is meant to make of all this is not exactly clear – is it a warning about the future, is it a plea for understanding, is it setting the scene for what follows – but the impression it leaves is that judges are likely to give great latitude to the ATO in transfer pricing cases, perhaps more than would occur in other areas of tax law:

the ultimate purpose is to determine the consideration that would have been given (that is implicitly, by the taxpayer) had there not been a lack of independence in the transaction. How one comes to that assessment and the relationship between the posited arm’s length dealing and what in fact occurred will depend on the circumstances at hand, and a judgment as to the most appropriate, rational and commercially practical way of approaching the task consistently with the words of the statutory provision, on the evidence available... Given the great variety of commercial circumstances to which the provision may apply, it would be wrong either to...
approach the interpretation of the provisions pedantically or to dictate a rigid or fixed approach to the task of determining the arm’s length commercial consideration.

And perhaps this is best demonstrated in his Honour’s comments about just what was open for debate in a transfer pricing dispute. The Court said CAHPL’s argument basically limited the Court to finding the price of a loan on these very terms:

the task at hand [was] to price the interest rate that would be paid by a stand alone borrower from an independent lender for a loan structured in the identical terms to the credit facility ...

But his Honour clearly was not going to be constrained to just pricing a loan with these specific features; the features must also be disputable:

That approach, however, almost dooms to failure the application of Div 13 if its task is to substitute commercial reality based on independence, for intra-group reality based on group control. All one would have to do would be to constrain internally the transaction to give the highest price and include or omit terms of the agreement that would never be included or omitted in an arm’s length transaction and which are not driven or dictated by commercial or operational imperatives, as the foundation for assessing an hypothesised arm’s length consideration. Such unrealistic inflexibility would undermine the sensible operation of the Division by a rigid construction of the hypothesis in a shape and form controlled by the taxpayer.

3. Some lessons are universal; some are not

The case was fought by the taxpayer on a multitude of fronts, including procedural, tax treaty, administrative law, constitutional and penalty issues, as well as the substantive matter on which we focus here: was the interest paid by CAHPL excessive?

Given the duplicate sets of rules in play, the Court had to answer that question first by applying the provisions of Div 13, and again by applying the words of Div 815-A. While the trial judge and the Full Federal Court reached the same answer under both sets of rules (the interest was excessive), the judgments analyse each regime separately. So it is worth noting that the lessons which emerge for one regime must be transposed with some caution when interpreting the other. Some lessons may be universal, but others will be peculiar to the words being interpreted. The trial judge emphasised this at first instance criticising submissions put to him as seeking ‘to align Div 13 and Subdiv 815-A without sufficient regard to the different language of the two sets of provisions.’

Secondly, while the lessons about the old law in Div 13 will become less useful as the years to which Div 13 applies recede into history, the lessons about Div 815-A are probably a good pointer to the interpretation of the provisions which replaced it: Div 815-B is couched in very similar terms and applies (to the exclusion of Div 815-A) to income years starting on and after 29 June 2013.

4. The Div 13 hypothetical

All the judges devoted most of their time to Div 13 as it operated during the 5 years of the Facility. Presumably their thinking was, if the ATO’s amended assessments were not excessive under Div 13 for all the years then their validity under Div 815-A for just some of those years did not really matter. The trial judge had said that ‘if CAHPL’s Div 13 case had succeeded, only then would it be necessary to consider Subdiv 815-A …’

The structure of Div 13 involves four core elements: the property acquired, the consideration actually paid for it, whether the parties were dealing at arm’s length and whether the consideration given matches a hypothetical amount – the amount ‘that might reasonably be expected to have been given …’ for that property. Where Div 13 is enlivened it substitutes the ‘arm’s length consideration’ for the price actually paid.
The parallel with Part IVA (which was not argued by the ATO in *Chevron*) is obvious – we know what actually happened, but the taxpayer is to be taxed on the basis of a hypothetical – a transaction at a price ‘that might reasonably have been expected’ to happen. As Pagone J puts it, ‘the comparison required to be undertaken ... is of the consideration for the property actually acquired with the arm’s length consideration (as defined) of a hypothetical agreement.’

Any time the law amounts to, ‘let’s ignore what actually happened and just pretend ...’, there are bound to be problems. The obvious question is how much latitude is allowed in coming up with other possibilities? Or put the other way, how much of what actually happened in the real world – especially with regard to the property and the parties – has to exist in the hypothetical world? As it turns out, the real world is an important constraint on the hypothetical world.

**Must the ‘property’ be exactly the same?** Perhaps surprisingly, defining the ‘property’ involved in the transaction was a hotly contested issue – the ATO argued the property was just the amounts actually advanced while CAHPL argued that the property was the entire bundle of rights and obligations under the Facility.

While this might look like mere pedantry, the reason for this dispute is because of the importance of the term ‘property’ elsewhere in Div 13. If CAHPL was correct and the ‘property’ it acquired consisted of both the money lent and other critical terms of the Facility (especially not having to give security or not having to make covenants), then, it argued, the hypothetical arm’s length price must be the price that would be paid for a loan on those same terms.

This issue had been raised in the trial; the ATO had argued that the ‘property’ acquired under the hypothetical transaction could involve, ‘terms different from those of the actual agreement… In other words, the transaction to be priced (and taxed) could involve rather different property from the property under the transaction that actually occurred. Robertson J, however, had insisted that the hypothetical transaction had to involve the same ‘property’ and the Full Court agreed. The hypothetical transaction could not, ...

... alter the property acquired. Division 13 of the ITAA 1936 does not, in my opinion, require or authorise the creation of an agreement with terms different from those of the actual agreement, other than the consideration.

This argument was important to CAHPL but it has much broader implications when considering the range of permissible comparables in any transfer pricing dispute. If the only comparable transaction is one involving the same property, the range of comparables could be very limited in the real world.

While the Full Court agreed with CAHPL that the property acquired by CAHPL under the international agreement was the rights and benefits arising under the Facility, it nevertheless did not produce the result CAHPL hoped for. Both Allsop CJ and Pagone J took the view that while the borrower received a bundle of rights under the Facility, the borrower did not also acquire the absence of security or covenants: that was not part of the ‘property.’ Not being part of the property actually acquired, the absence of security and covenants did not need to feature in pricing the property under the hypothetical transaction.

But it remains unclear just how much of the actual Facility must appear in the hypothetical Facility. For example, the Facility had a life of 5 years and the borrower could repay any funds drawn down at any time. Would the hypothetical loan also have to include these terms? The Court says yes, but almost without thinking about it. Allsop CJ says,

one asks what consideration might reasonably be expected to have been given or agreed to be given between independent parties in respect of the acquisition of the right or benefit of a five year loan with a right in the borrower to prepay at any time.

While the Full Court agreed that the property had to be the same, Allsop CJ then qualifies what this means: if you have to assume that the parties are independent, then you may also have to assume
some variation between the property actually acquired and the property that would be acquired. He puts it this way:

[there may be situations] where the agreement in question is not easily commercially replicated ... in the real world ... because the property may be such as to be of special particularity to the taxpayer or to the group in which the taxpayer is situated ... that it may be constructed in a way divorced from how such would be likely to appear as a dealing between independent parties. [But] the hypothesis must be made to work [and so] the property, the acquisition, the consideration are to be seen in their relationship to each other by reference to what can be reasonably expected, assuming independent commercial parties.

This appears to relax the strict identity between the property actually acquired and the property to be priced in the hypothetical agreement. That relaxation will matter when the argument involves disputes about just how closely alleged comparables need to match the property actually supplied.

Can the ATO change (or mandate) the property? Another very important aspect of the debate about the 'property' involved in the transaction revolved around the currency. The terms of the Facility referred to the US company advancing of 'the equivalent in Australian Dollars ... of Two Billion Five Hundred Million United States Dollars' and payments by CAHPL under the loan 'will be made in Australian Dollars ...'

Two drawdowns were made under the Facility and the funds were credited to the taxpayer’s US Dollar bank account. The ATO took the position that this meant the property acquired by CAHPL was actually US dollars. Both the trial judge and the Full Federal Court took the view that the transaction actually occurred in AUD so the ATO failed on the facts – Allsop CJ said he would 'treat the receipt of funds in Australian dollars.'

But the ATO had a fall-back position: even if the transaction actually occurred in AUD, nevertheless the hypothetical transaction would not have been denominated in AUD; arm’s length parties would have done the deal in USD. Given that the interest cost of AUD is invariably higher than USD, the obvious consequence is that a hypothetical transaction denominated in USD was likely to be cheaper.

The trial judge and the Full Federal Court disagreed with this proposition. The Court acknowledged that the funds raised by CFC were in USD and so there was at least some basis 'for a different reasonable expectation' that the hypothetical loan would be in USD. But the trial judge concluded that even the hypothetical loan might be expected to be in Australian currency for two reasons – it meant CAHPL would not face exposure to currency risk and CAHPL needed the money to refinance debt that was already in AUD. He said he was,

... not persuaded that the ... AUD currency [of the actual loan] differed from the condition as to currency which might have been expected to operate between independent enterprises dealing wholly independently with one another.

Pagone J said, 'there is no reason to depart from ... [the trial judge’s] conclusion that the hypothetical agreement might reasonably have been expected to be in Australian currency.'

Who is the hypothetical borrower - is it identical or just similar? The next set of issues involve the parties to this hypothetical transaction. The arm’s length price is ‘the consideration that might reasonably be expected to have been given ... if the property had been acquired under an agreement between independent parties dealing at arm’s length ...’ But who are these independent parties, and what do we know about them?

This is not a new question. In Commissioner of Taxation v SNF (Australia) Pty Ltd [2011] FCAFC 74 (SNF), the ATO had argued that the hypothetical purchaser had to share ‘each and every quality of the taxpayer ... save for the solitary fact ...’ that it was controlled by a foreign parent. (The implication of the ATO’s argument was that none of the companies or transactions presented as comparable were
comparable because the parties to them were not absolutely identical to SNF.) The Court had rejected this bar as too high.

**Who is the hypothetical borrower – a stand-alone company?** In *Chevron*, the ATO argued for a similar approach but for a different reason – they wanted the hypothetical borrower to be a company that was part of a substantial worldwide group, CAHPL itself being part of a worldwide group. The implication now was that a borrower which was part of a sizeable group would inevitably be able to borrow at a cheaper cost than a stand-alone company (often referred to as an ‘orphan’) because of the so-called ‘implicit support’ of the parent company.

The trial judge and the Full Court agreed with the ATO’s position. Allsop CJ said the issue was to assess what ‘the taxpayer or a person in the position of the taxpayer …’ would have paid. Pagone J said,

> The actual characteristics of the taxpayer must, therefore, ordinarily serve as the basis in the comparable agreement [but] that does not mean that all of the taxpayer's characteristics are necessarily to be taken into account.

The trial judge and the Full Court both concluded that the hypothetical borrower should be a company which is a member of a group. That is, CAHPL’s ‘orphan theory’, being that it should be assessed on a stand-alone basis and not as a member of a group, has been roundly rejected. Pagone J said,

> The prediction of what might reasonably be expected is not to be undertaken upon the hypothesis submitted on behalf of [CAHPL] that it was not a member of the Chevron group or, in the language sometimes used in this context, as if it were an orphan. To do so would distort the application of Division 13 ...

But while this issue of affiliation was hotly debated, it is not obvious that it mattered on the facts of the case. CAHPL had led evidence which the trial judge accepted, ‘that in the absence of a legally binding parental guarantee, implicit credit support had very little, if any, impact on pricing by a lender in the real world.’ Apparently commercial lenders don’t care as much about this issue as the ATO had thought.

**Does the hypothetical borrower share the borrower’s limitations?** The starting position that a hypothetical borrower is ‘in the position of the taxpayer’ creates its own set of problems.

The ATO argued that the interest rate paid by CAHPL was too high because the borrowing was unsecured, or the borrower did not bind itself by giving financial and operating covenants, or the parent did not guarantee repayment of the loan, or all of the above.

But CAHPL led evidence that its assets were shares in 2 companies and it could not actually grant a charge over the production assets held by those subsidiaries – the other joint venturers already held a first charge over the assets and CAHPL was prevented from charging them. Is the hypothetical borrower similarly constrained?

This difficulty appears not to have troubled either the trial Court or the Full Court so we do not yet have a reasoned view about just what relevance other peculiarities of the actual borrower will play in constructing the hypothetical borrower.

**What does the hypothetical borrower do?** Clearly risk will play an important role in setting the price at which a hypothetical lender would be willing to lend but not all borrowers are in risky businesses and even risky operations (like oil or gas exploration) sometimes succeed. So what do we pretend the hypothetical borrower’s risk profile looks like?

The trial judge had concluded –

> in the hypothetical, the hypothetical independent parties have the characteristics relevant to the pricing of the loan so as to enable the hypothesis to work. Thus, for example, the borrower will be an oil and gas exploration and production subsidiary
The Full Court agreed. It seems the industry matters. So too does the state of the business and the market: there was evidence from the bankers (their evidence was treated as relevant) that the hypothetical lender would look at ‘proved reserves’ in setting the interest rate.

The hypothetical lender. Similar questions arise for the other mythical party to the hypothetical transaction. Must we assume the lender is a single entity because the actual lender was a single entity? Must we assume it also was an SPV? Must we assume it has only one customer? Must we assume that it is willing to accept the currency risk?

The Full Court emphasises that one thing is clear: ‘the one fixed and rigid proposition is that the parties to the [hypothetical] dealing ... must be independent from each other – mutually independent,’ but beyond that, we are not given much guidance about the other party.

Issues about the characteristics of the lender may become relevant for lenders which operate in different markets to the actual lender, or who would wish to charge a premium or allow a discount for their own business reasons, or who don't lend to risky borrowers and so focuses principally on maximising cash flow, or who are willing to rely on the implicit support of the parent rather than insist on a written guarantee.

What price would these hypothetical parties pay for this (hypothetical) property if they were dealing at arm’s length, and how would they pay it? There is an oddity at the heart of the Chevron case which the Courts fail to address squarely.

The result of the case is that the consideration paid by CAHPL (the interest) was excessive, and the Courts conclude the interest is excessive because something else was lacking. But it seems the ‘something else’ was also ‘consideration’: Allsop CJ notes that the trial judge ‘... concluded that consideration in the nature of security or operational covenants would have been given ...’ and Pagone J refers to ‘the lack of security [as] an absence in the consideration ...’. Given that the missing bit was also ‘consideration,’ then the case is actually a dispute about the form in which the consideration was provided, rather than the amount – CAHPL gave all of its consideration in the form of interest; the hypothetical borrower would have given some of the consideration in the form of interest and the balance of the consideration in another way.

This issue about what the consideration should have been (or what the components of the consideration should have been) is one of the few areas where, very importantly, the judges disagree. They all agree that the amount of interest was excessive but they do not agree about what the consideration would have been under the hypothetical loan -- ‘the consideration that [CAHPL] or a borrower in its position might reasonably be expected to have given to an independent lender if it had sought to borrow AUD 2.5 billion for five years ...’:

- at first instance, Robertson J had concluded that, ‘if the property had been acquired under an agreement between independent parties dealing at arm’s length with each other, I find that the borrower would have given ... security and operational and financial covenants ...’ as well as interest. Robertson J accepted CAHPL’s submission, ‘that in the absence of a legally binding parental guarantee, implicit credit support had very little, if any, impact on pricing by a lender in the real world’. And Robertson J did not assume that CAHPL’s parent would have in fact provided an actual guarantee;

- on appeal, Allsop CJ took a different approach, concluding that, ‘the consideration that might reasonably be expected to be given by a company in the position of [CAHPL would be interest plus] the giving of a guarantee of [CAHPL’s] obligations to the lender by a parent such as Chevron ...’. Allsop CJ said that there may have been a question, on the evidence, whether CAHPL was in a position to give security. On the evidence, the reasonable expectation would be that Chevron or a company in Chevron’s position would give a guarantee and so security and any covenants given by CAHPL or the company in its position would be of no relevant consequence;
Pagone J initially agreed with the trial judge saying, 'there is no reason to depart from that conclusion.' But his subsequent analysis discusses the Chevron group policy, 'to obtain the lowest cost of funding to the group for external borrowing …' and discusses the impact of a possible guarantee by the parent. The impression which emerges is that in his Honour's view, the hypothetical loan would have (i) been secured and (ii) have covenants and/or (iii) a parental guarantee.

The implications of these differing predictions for the interest rate on the hypothetical 'arm's length loan' are obvious but it is not clear whether the hypothetical loan is the one assumed by Robertson J, Alsopp CJ or Pagone J. Unfortunately, our legal system does not work in a way that produces one correct answer – under every one of these substitutes the interest rate actually paid by CAHPL was likely to be excessive.

**And are there other amounts that would have to be paid?** Hidden inside this disagreement about the terms of the hypothetical loan is a further question about identity. In the approach of Robertson J, all the consideration for the hypothetical loan is given by CAHPL (in the form of interest, covenants and security). But in the approach taken by Alsopp CJ and Pagone J, the parent (initially) bears some of the cost of borrowing under the hypothetical loan. Does that mean the amended assessments are still excessive because CAHPL ought now to be paying a fee to Chevron for guaranteeing its debts (offsetting the reduction to the interest rate)? Pagone J noted ‘there is force in the proposition that a cross-border guarantee by the United States parent for the benefit of its Australian subsidiary to raise funds in the United States market with the benefit of a guarantee from the United States parent might have attracted a fee from CAHPL to CVX’ and he noted that OECD Transfer Pricing Guidelines contemplate a cross-border guarantee by a parent to a subsidiary ‘may’ require the payment of an arm’s length guarantee fee. The issue would then be, what level of guarantee fee should be assumed?

Both Allsop CJ and Pagone J dealt with this argument by saying the evidence did not reveal any likelihood of Chevron charging a fee for such guarantee. In the absence of that evidence, the impact and the size of a hypothetical fee was dismissed.

**Evidence to prove the arm’s length price.** While the appeal largely repeated most of the arguments led at first instance, there was progress on some issues.

One of the striking features of the trial was just how many witnesses were led by each side – 12 for the taxpayer and 7 for the ATO – and just how varied were their fields of expertise: commercial lenders, a banking regulator, credit rating agency employees, an expert in debt practices in the oil and gas industry, transfer pricing economists, an accounting expert, an expert on US tax law and a former US treaty negotiator. Robertson J at first instance was more than a little critical of some of the experts and their evidence and its relevance to the issues before him (‘I give no weight to the opinions of transfer pricing economists where those opinions appear not to be founded in the statutory language which the Court must apply’).

But one matter which required some consideration among the competing evidence was just how one goes about proving what the interest rate on the hypothetical loan should be. Who can give that evidence and what is it meant to show?

It seems clear that neither side was entirely confident about this. CAHPL had originally obtained pricing opinions from two investments banks when it set up the Facility in 2003. At trial, the taxpayer led evidence from two commercial lenders about how bank lenders would go about pricing the loan; the ATO led evidence from an oil industry expert, and a transfer pricing economist but the essence of the evidence was to show how credit ratings agencies would rate CAHPL. The evidence of the commercial lenders was that, ‘lending institutions did not rely on [credit agency] ratings to make lending decisions or to price loans.’

Robertson J concluded that Div 13 required the Court to price the hypothetical loan from the ‘perspective … of a commercial lender [and] not approach the question of the borrower’s
creditworthiness in the same way as ... a credit rating agency ...' At the appeal it appears the ATO accepted this position and the Full Court did not re-examine the issue. This made the evidence of CAHPL's two banking industry witnesses very important, and unhelpful. Pagone J drew attention to evidence that 'most term loans extended to B+ rated borrowers [were] secured and that the typical loan facility arrangements had tight loan covenants.'

The need to try and find truly comparable third party evidence still remains, Pagone J saying

in each case the focus of inquiry must be to identify a reliable comparable agreement to the actual agreement by the actual taxpayer for the legislative assumption to have meaningful operation. The provisions of Division 13 are intended to operate in the context of real world alternative reasonable expectations of agreements between parties and not in artificial constructs. The comparable agreement may, therefore, usually assume an acquisition by the taxpayer of the property actually acquired under an agreement having the characteristics of the agreement as entered into but otherwise hypothesised to be between them as independent parties dealing with each other at arm’s length in relation to that acquisition. The purchaser (or in this case the borrower) may therefore, as his Honour considered at [79], be a company like CAHPL which is a member of a group, but where the consideration in respect of the acquisition identified in the hypothetical agreement is not distorted by the lack of independence between the parties or by a lack of arm’s length dealings in relation to the acquisition.

5. The Div 815-A hypothetical

As noted above, detailed analysis of the interim transfer pricing rules in Div 815-A would have been very helpful for the interpretation of the final provisions in Div 815-B which replaced them in 2013. Unfortunately, the Full Court’s analysis of Div 815-A is far less elaborate than its thinking on Div 13. And there is no cross-referencing in the judgments – even though both regimes are about transfer pricing and they are both constructed around notions of ‘arm’s length’ amounts.

One place where this lack of a common objective can be seen is when one asks, so just what do taxpayers do now? The implications for taxpayer behaviour under Div 13 seem to be clear after Chevron – the judges hint that a taxpayer can avoid problems (maybe) if it offers security or finds a guarantor or includes covenants or maybe all of the above, but the taxpayer probably doesn't have to transact in a different currency or accept currency risk. The real loan will then match the hypothetical loan. But the Div 815-A analysis is quite unspecific and there is little in the Courts' analysis of Div 815-A to answer the question, so what does a taxpayer do now? The new transfer pricing law focuses just on producing a different number without explaining how to reach it; the old law focussed more setting out a method which leads to a number.

The structure of the interim transfer pricing rules in Div 815-A involves four core elements: the parties are associates in the sense used in a tax treaty (that meaning involves both an ownership or control test, and a requirement that the parties are not dealing at arm’s length); the ‘conditions’ operating between the parties in their dealings differ from the conditions under which arm’s length parties would be dealing; there is a hypothetical amount of profits which might have been expected to accrue to an Australian entity but didn't; and a causal test: the profits did not accrue 'by reason of those conditions.' When these requirements are met, the ATO can make a determination to substitute a hypothetical amount for the taxpayer’s actual taxable income.

So while Div 815-A is constructed using different terms from Div 13, at its heart, it too is built on hypothesis and speculation:

- the conditions which the parties might have agreed upon to regulate their dealings, but didn't; and
- ‘an amount of profits which ... might have been expected to accrue to [an Australian] entity’ but didn't.
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What are the ‘conditions’ and where are they to be found? The trial judge had drawn attention to a number of facts to conclude that the dealings between CAHPL and its US subsidiary did not reflect the conditions that might have applied between independent parties. The facts can be grouped into these ideas:

- common ownership: CAHPL owned the lender (CFC), and both companies were ultimately owned by the same parent (CVX);
- exclusivity: the US lender was a SPV set up for just this transaction; it borrowed just to lend to CAHPL which was its sole customer;
- subjugation: the treasury company of the corporate group decided how much CAHPL would borrow, for how long and on what terms; there was no bargaining about these issues.

CAHPL argued that the trial judge made a mistake in the way he handled this requirement because he was not looking at the right thing: the wording suggests the inquiry is confined to looking at the terms of the loan [the ‘conditions’] to see if they are affected and how, but the judge was looking at the entire commercial environment in which that deal was struck: who owned whom, frequency of dealings, and so on.

The Full Court reached the conclusion that the ‘conditions’ which applied in fact were not conditions that might have been expected between arm’s length parties, but again their approaches show some divergences. Allsop CJ focussed on one ‘condition’: the fact that everything was being dictated by US corporate treasury and for the benefit of the group rather than CAHPL, while Pagone J said, ‘the identification of [the] conditions permits a broad and wide ranging inquiry into the relations existing between the enterprises concerned.’

What would the arm’s length conditions have been? The taxpayer had tried to insist that the ATO must ‘explicitly state how [a particular condition] would differ from the condition which might be expected to have operated between independent enterprises.’ The trial judge had rejected this requirement but this task can’t be ignored. The judges must give meaning to ‘the conditions that would apply between independent parties dealing wholly independently with each other’ in order to be able to conclude that the actual conditions depart from that paradigm.

The definition of the arm’s length conditions will matter for issues like, does evidence of actual bargaining between the parties matter, or is ownership by the same ultimate parent always fatal?

Cause and effect. The taxpayer had also tried to insist at the trial that the ATO must identify how each identified condition was said to have impacted on the pricing of the loan and to have resulted in the non-accrual of profits.’ The trial judge rejected imposing this as a requirement of the ATO, but finding a causal connection between the non arm’s length conditions and the missing profits is mandated in the legislation – there must be profits which are missing ‘by reason of those conditions …’

This element creates a tension that will require some care: the more expansive the circumstances that are said to be ‘conditions,’ the less likely it is that many of them will have any impact on the profits. For example, CAHPL led evidence that commercial lenders do not put much value on ‘implicit support’ – the possibility that a parent might choose to come to the rescue of a struggling subsidiary. As noted above, the trial judge said he accepted CAHPL’s submission, ‘that in the absence of a legally binding parental guarantee, implicit credit support had very little, if any, impact on pricing by a lender in the real world.’ Being part of a group might be a relevant condition but it is not one that will have an impact on profits.

The judges’ theories about what this causal test means seem to diverge:

- Allsop CJ looked at the Transfer Pricing Guidelines saying that, in his view, the Guidelines illustrate that, ‘the causal test … is a flexible comparative analysis that gives weight, but not irredeemable inflexibility, to the form of the transaction actually entered between the associated
enterprises.' This is odd. The passages he cites refer to the ability to re-construct the terms of a transaction, in addition to its price. They say nothing about causation;

- Pagone J adopted a more conventional approach saying a 'but for' tests asks whether something was 'a necessary condition' of the occurrence. A 'but for' test is typically understood to be a low bar to meet and this passage supports that idea: the conditions don't have to generate the result, they just have to be a necessary element.

**Were there missing 'profits'?** One design difference between Div 13 and Div 815-A is that the old law operated at the level of the individual transaction, changing the consideration for an acquisition of an item of property; Div 815-A operates on the overall result, changing the amount of taxable income, but only where there is an 'an amount of profits which ... might have been expected to accrue' but didn't.

The requirement is missing 'profits,' not missing 'taxable income,' and that creates a difficulty in a situation like this where CAHPL actually retrieved (almost all) the excessive interest payments, albeit in the form of non-assessable dividends. To see the issue, contrast these 2 transactions:

- **Transaction 1:** CAHPL paid $1m as interest to its US subsidiary and the $1m is then returned as a dividend;
- **Transaction 2:** CAHPL paid $1,000 as interest to its US subsidiary and $1,000 is then returned as a dividend.

In each case the 'profits' of CAHPL are the same and unaffected by an interest expense whatever the rate, so it is hard to say that in Transaction 1 there is 'an amount of profits which ... might have been expected to accrue to [CAHPL but has] not so accrued.'

The trial judge and the Full Court both acknowledged this is a problem. Allsop CJ says,

> If one ... compares the profits of CAHPL in the two scenarios one may not see a difference in amount of profits, although the two amounts would be differently formulated. In the actual transaction the profits are made up of lower (assessable) operating profit and higher (non-assessable) dividend income from CFC. In the hypothesised transaction the same level of profits are made up of higher (assessable) operating profit and lower (non-assessable) dividend income from CFC.

The ATO argued that the word 'profits' was the same as 'taxable income' so the requirement was satisfied because there was missing taxable income, but the trial judge and the Full Court all rejected that solution. The judges' own proffered solutions to this conundrum were many and varied and, with respect, unconvincing:

- Robertson J accepted that word 'profits' is not the same as 'taxable income' (ie, there really is a problem here) but he seems to insert the words '... and taxed accordingly ...' (from Art 9 of the US treaty) into Div 815-A with the apparent effect that Div 815-A is triggered once there is missing taxed profits;
- Allsop CJ says the 'profits' could be different if one adjusted the time frame (between the payment of the interest and the receipt of the dividends);
- and then he says, the 'profits' would definitely be different if we reverted to focussing just on the individual transaction and not the overall result – ie, there would be missing 'profits' if we just count the interest (and ignore the dividends);
- Pagone J accepts that 'the word 'profits' in the provision and in Article 9 is used in a more generic sense than 'taxable income' and that 'there is no basis in the text of the provisions or in the policy they express to equate the profits referred to with the taxable income of the taxpayer' all of which would seem to lead to the conclusion that CAHPL has a good point. But his Honour just rejects the
problem: ‘The fact that [CAHPL] received dividend income ... does not result in the conclusion that there was no amount of profits which did not accrue ...’

**How much extra profit might have been expected?** At this point there is a linguistic difference between Div 13 and Div 815: Div 13 substitutes the amount ‘that might reasonably be expected to have been given ...’ for the loan; Div 815-A allows the ATO to substitute an amount of profits that ... might have been expected to accrue.’ But the really significant difference is that the new transfer pricing law (both the interim and final versions) specifically directs the Court work out the amount of the missing profits in a manner consistent with the OECD *Transfer Pricing Guidelines* and other listed documents.

So what do the *Guidelines* say about this? Allsop CJ quotes extensively from the *Guidelines* which (at that time) said the tax authorities should price,

... the transaction actually undertaken by the associated enterprises as it has been structured by them ... In other exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise ...

The *Guidelines* allowed 2 exceptions – where ‘the economic substance of the transaction differs from its form’ and where ‘the arrangements ... differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.’

This sounds like a resounding endorsement of the line that CAHPL had taken, viz, the relevant issue is to price a loan between independent parties but with these very terms. This was not a case where ‘the substance differed from the form’ and there is nothing about pricing an unsecured and unguaranteed loan which is beyond the practical capacities of the ATO.

Allsop CJ did not agree. He would have substituted ‘a borrowing cost conformable with Chevron’s AA rating, which, on the evidence, would have been significantly below 9%.’ This is possibly lower than the amount which the ATO’s amended assessments had allowed. And it may even be different from the amount which he concluded Div 13 would have allowed: borrowing by CAHPL but with a guarantee by the parent.

It is intriguing that Pagone J does not refer to the *Guidelines*. Rather, he says ‘the comparison ... to be undertaken is akin to that contemplated by Division 13.’ He takes this to be, a loan at a lower interest rate ‘with security provided by its parent.’

### 6. OECD guidance on guarantee fees

The most significant difference between the trial Court and the Full Federal Court lies in the changed speculation about what might have happened. Robertson J said CAHPL would have given security and provided covenants (and implicit support is ignored by the market); the Full Court says CAHPL would have borrowed at a rate which assumed the benefit of an explicit guarantee given by Chevron. The assumption that the loan would be guaranteed raises the consequential question, should a guarantee fee also be assumed?

**Actual v. implied guarantees.** The latest version of the OECD *Transfer Pricing Guidelines* contains the following comments about guarantee fees, differentiating between implicit support (which does not justify a fee) and an explicit guarantee (which does):

**Para 7.13:** Similarly, an associated enterprise should not be considered to receive an intragroup service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it
would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefitted from deliberate concerted action involving global marketing and public relations campaigns. In this respect, passive association should be distinguished from active promotion of the MNE group’s attributes that positively enhances the profit-making potential of particular members of the group. Each case must be determined according to its own facts and circumstances. See Section D.8 of Chapter I on MNE group synergies.

More specific guidance can be seen in this example:

**Example 2** – Para 1.167 The facts relating to S’s credit standing and borrowing power are identical to those in the preceding example. S borrows EUR 50 million from Bank A. The functional analysis suggests that Bank A would lend to S at an interest rate applicable to A rated borrowers without any formal guarantee. However, P agrees to guarantee the loan from Bank A in order to induce Bank A to lend at the interest rate that would be available to AAA rated borrowers. Under these circumstances, S should be required to pay a guarantee fee to P for providing the express guarantee. In calculating an arm’s length guarantee fee, the fee should reflect the benefit of raising S’s credit standing from A to AAA, not the benefit of raising S’s credit standing from Baa to AAA. The enhancement of S’s credit standing from Baa to A is attributable to the group synergy derived purely from passive association in the group which need not be compensated under the provisions of this section. The enhancement of S’s credit standing from A to AAA is attributable to a deliberate concerted action, namely the provision of the guarantee by P, and should therefore give rise to compensation.

However, the above example is not the last word from the OECD on this subject. The following Note relates to the above example:

**Note 6** - Example 2 should not be viewed as providing comprehensive transfer pricing guidance on guarantee fees in respect of financial transactions. Further guidance will be provided on transfer pricing for financial transactions including identifying the economically relevant characteristics for determining arm’s length conditions. This work will be undertaken in 2016 and 2017.

The additional OECD work referred to is still in progress and the OECD has updated the timetable saying it will now be forthcoming in the Northern hemisphere summer.

It is important to note, however, that these two passages are mainly directed to the question, is the parent entitled to a fee (and is the borrower entitled to a deduction) when it actually guarantees the subsidiary’s debts? They don’t squarely address the Div 13 question, is the parent entitled to a fee (and is the borrower entitled to a deduction) when it is only presumed to be guaranteeing the subsidiary’s debts?

**Guarantees given to external lenders v. guarantees to internal lenders.** The OECD’s guidance relates to the common situation where a parent company (i) actually guarantees a subsidiary’s debt and (ii) the debt is borrowed from an external lender.

The Full Federal Court decision raises an intriguing question about whether the same logic applies to debt borrowed from an internal lender (such as CFC). Or to put this another way, if a parent company were to provide an explicit guarantee for a subsidiary’s borrowings from another member of the group, can the parent charge a fee for this service which the borrower could deduct? And there is an even more speculative question: if a parent company is only presumed to guarantee a subsidiary’s borrowings (being borrowing from another member of the group), can the parent charge a fee for this presumed service which the borrower could deduct?
7. Implications

It remains to be seen whether CAHPL will seek leave to appeal to the High Court. It would be surprising if it not to do so. The results so far have been mixed – CAHPL has won several skirmishes but so far not the war. And it remains to be seen whether the High Court has an appetite to write some new law in this field, especially given that Division 13 is now ‘old law.’

But it may be that CAHPL has won one battle that both sides care about deeply, the question of the currency. The ATO took the unusual position on appeal that the original judgment was correct, but for different reasons, arguing the judge should have found the loan in question (and the loan to which it should be compared) was in USD, not AUD, which would mean the interest rate was excessive. It seems the ATO can constrain interest expense by insisting that an intra-group loan be secured, or guaranteed, or contain covenants, or all of the above. But if the ATO cannot insist that the loan be denominated in a strong currency then there may still be a sizeable margin to be charged above CFC’s cost of funds.

Further, insisting that there be a guarantee may mean that parent companies will change their practice to provide an explicit guarantee, and then quite rightly demand a guarantee fee. The local borrower will presumably pay a reduced interest rate to the intra-group lender, but the revenue effect of that reduction will be offset to some extent by a new deduction, being the guarantee fee paid to the guarantor (and guarantee fees are not liable to interest withholding tax when paid to non-residents).

For the moment, and until further guidance emerges from the High Court and/or the ATO, a summary of some implications of *Chevron* for other taxpayers is as follows:

- The Full Federal Court has now made it very clear that an Australian subsidiary of a multinational group is not to be treated as if it were an ‘orphan’ when undertaking transfer pricing arm’s length calculations. In fact, some level of parental support may need to be assumed to exist depending on the facts/situation.

- If a borrower is part of a group that has a policy to borrow externally at the lowest cost and that has a policy that the parent will generally provide a third party guarantee for a subsidiary that is borrowing externally, then in the case of related party debt, the interest rate payable by an Australian subsidiary should probably be set at a level that assumes a parent company guarantee has been given.

- As a result, the appropriate interest rate on internal debt will likely be closer to the parent’s global cost of funds for the relevant currency.

- It remains to be seen whether pretending that the debt was raised with the benefit of a guarantee given by the parent carries the further implication that the borrower can also pretend it paid a fee for the benefit of that fictitious guarantee.
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