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4 July 2017

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Dear Shaz,

Practical Compliance Guideline PCG 2017/D4: Submission

1. Greenwoods & Herbert Smith Freehills thanks the Australian Taxation Office (**ATO**) for the opportunity to make a submission on Draft Practical Compliance Guideline PCG 2017/D4: *ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions* (**Draft** or **PCG)**.

2. As will be evident from the comments below and in the Appendix to this letter, we have a number of significant concerns with the Draft and we urge the ATO to reconsider it very carefully.

3. We have been surprised recently to see Foreign Investment Review Board (**FIRB**) approval for simple Australian property investments become dependent on an extensive and extremely onerous investigation of the foreign owned Australian purchasing vehicle by the ATO, applying the concepts in the Draft. Our concerns (and the concerns of taxpayers, the professional bodies and industry bodies) regarding FIRB approval being conditional on ATO review and sign off is a separate matter outside the scope of this submission. However, if the concepts in the Draft are going to be applied by the ATO in this context, we think that it is imperative that the points raised in our submission are addressed as a matter of urgency. Application of the concepts in the Draft, in the context of the FIRB approval process, pose a significant threat to completion of commercial deals in Australia.

General comments

4. *CTA Submission endorsed*: We have had the benefit of reviewing the 30 June 2017 submission lodged by the Corporate Tax Association (**CTA**) in respect of the Draft. We endorse and support the comments made by the CTA and do not seek to repeat here all the issues made in its submission.

5. *Purpose of the PCG*: It is clear from para 78 of the Draft, that the only purpose of the PCG is to address risks limited to the application of the transfer pricing rules in Division 815 of the *Income Tax Assessment Act 1997* (the **Act**), or an international tax agreement/double tax treaty. It is also made clear that the Draft does not set out the approach of the ATO to reviewing other taxation issues that might arise in relation to related party debt including, but not limited to: the application of the debt/equity rules; the substantive deductibility of interest payments or other losses; the application of the thin capitalisation rules; the existence or otherwise of liability for interest withholding tax; or the application of Pt IVA of the Act.

6. *(Ir)relevance of certain risk indicators*: Viewed against the purpose of the PCG noted above, a key concern we have with the Draft is that a number of the 11 specified “risk indicators” in the Schedule to the Draft, and summarised in the table in para 82, seem to have, or at least should be seen as having, little or no bearing on whether the interest rate on a related party loan is in fact at arm’s length or not.

7. Para 83 of the Draft states:

> *Determining your 'risk zone' essentially involves assessing the extent to which the ATO considers the conditions that exist for your related party debt (or you have taken to exist for the purposes of pricing the related party debt according to arm's length conditions) might give rise to a transfer pricing benefit.* ***It does so using indicators the ATO considers relevant to determining the existence of arm's length conditions****.* (emphasis added)

8. In our view the following indicators are not reasonably *"relevant to determining the existence of arm's length conditions"* and of themselves have no relevance as regards the risk of inappropriate interest rates for transfer pricing purposes:

- Headline tax rate of lender entity jurisdiction
- Currency of debt is different to operating currency (see further comments below)
- At least one party is a hybrid entity
- Some of the so-called "exotic features" set out in para 131 of the Draft.

9. It is of concern that the CTA submission states: "*It is important to note that our survey results indicate the main drivers for cumulative individual totals being in the higher zones appear to be the currency of loans being different from the operating currency (and it seems that this is the case even if there was an arm's length hedge in place to bring that loan in line with the operating currency), the tax rate of the lender entity and the existence of hybrid entities*." In other words, taxpayers are primarily in higher risk zones based on "risk indicators" that, in our view, have no relevance as regards the risk of inappropriate interest rates or the existence of arm's length conditions.

10. Some of the other risk indicators would seem to also have questionable or low relevance to the task in question.

11. ***Significance*** *of a "poor" outcome*. As CTA notes in its submission, where a taxpayer falls into the Red zone, it is difficult to envisage a more serious set of circumstances facing a taxpayer than those set out in para 48 of the Draft:

> *"(a) reviews are likely to be commenced as a matter of priority*
> *(b) cases might proceed directly to audit*
> *(c) you will not be eligible for access to the APA program*
> *(d) the ATO is likely to use formal powers for information gathering*
> *(e) practically, it will be more difficult to resolve disputes through settlement or ADR*
> *(f) you might face an increased prospect of litigation."*

Para 56 provides that: "*If you are in the 'Red zone - very high risk'* ***<u>or</u>*** *are not dealing with us in a co-operative, constructive and transparent manner it is likely we will use our formal information gathering powers to obtain information and will not take an informal approach*." (emphasis added). We agree with the CTA that it would appear wholly reasonable to assume that only taxpayers that are engaging in extremely high risk or egregious activities or transactions should fall within such a category.

12. ***Likelihood*** *of a "poor" outcome*. Because of the serious consequences noted above, we would have expected that taxpayers would only fall into the Red zone in circumstances where there is a strong risk of incorrect transfer pricing. However, due to the inclusion of so many risk indicators with little if any bearing on incorrect pricing, it is evident that many taxpayers are going to (inappropriately and undeservedly) end up in the Red or Amber zones. The results of the CTA's survey, as set out in its submission, and our own anecdotal feedback from many of our clients, confirms this very likely outcome.

13. ***Consequences for taxpayers*** *of an underserved "poor" outcome*. The ramifications for a taxpayer finding itself in the Red (or Amber) zone could be very serious, both internally for the taxpayer, and also for its relationship with the ATO:

- *Internal consequences for taxpayers*: a Red or Amber outcome for a taxpayer can typically be expected to generate some considerable attention and focus within the multinational group. No doubt this is what the ATO hopes will happen. However, in many cases it is likely that despite the risk outcome, on any reasonable view of the facts, the interest rates in question are clearly at arm's length. In such a case, a taxpayer may conclude that no "behavioural change" is warranted, especially having regard to the tax implications and risks in other countries, i.e. on the other side of the loan(s) in question. In such situations, there may be much (unnecessary) internal stress and management time devoted to understanding how such a rating could have arisen; what to do about it and how to convince the ATO not to implement the actions set out in para 48 of the Draft.

- *Consequences for taxpayer/ATO relationships*: given how serious the consequences will be, where a taxpayer has ended up in the Red zone and on any reasonable view of the facts simply doesn't pose any transfer pricing risk, this may well cause considerable damage to the relationship between the taxpayer and the ATO. Many such taxpayers are likely to view the ATO's use of the "justified trust" concept with some circumspection as a result.

14. ***Consequences for the ATO*** *of undeserved "poor" outcomes for taxpayers*.

- Workload/resourcing problems: should more taxpayers end up in the Red or Amber zones than really warrant being there, the ATO will have created a huge workload and administrative burden for itself in trying to actually undertake all of the actions set out in para 48 of the Draft.
- ATO's reputation with taxpayers and foreign tax authorities: where large numbers of taxpayers end up being inappropriately in the Red or Amber zones, this is likely to adversely reflect on the ATO's reputation with both taxpayers and the revenue authorities of other countries.

15. *Tone down Red zone language*. In order to address some of the problems noted above, we strongly recommend that the ATO 'tone down' the confrontational language employed in the Draft, especially as regards the Red zone, e.g. in paras 48 and 56. There should be a clear acknowledgment that a taxpayer with quite unobjectionable arrangements may nevertheless have ended up inappropriately being deemed to be "very high risk" and that in certain circumstances a more informal and less confrontational approach will be employed by the ATO. (Para 51 is not currently sufficient in this regard.)

16. *Conflict with the* Chevron *case*. Para 7 of the Draft makes it clear that the PCG does not provide advice or guidance on the technical interpretation or application of Australia's transfer pricing rules or other taxation provisions. As a result, there is also no reference to any case law on transfer pricing, including the recent Full Federal Court decision in *Chevron Australia Holdings Pty Ltd v FCT* [2017] FCAFC 62 (***Chevron***). It is not obvious how the PCG is to be reconciled with either the decision in *Chevron*, especially as regards foreign exchange related issues. As set out in the Appendix, in our view not only does *Chevron* not support certain positions taken by the ATO in the Draft, if anything *Chevron* would appear to point in the opposite direction.

17. *ATO's "expectation*". Para 77 of the Draft is critically important and states:

> *"Generally, the ATO expects any pricing of a related party debt to be in line with the commercial incentive of achieving the lowest possible 'all-in' cost to the borrower. The ATO expects, in most cases, the cost of the financing to align with the costs that could be achieved, on an arm's length basis, by the parent of the global group to which the borrower and lender both belong. The indicators, and the weighting of the indicators, have been developed with this expectation in mind."*

The basis of this "expectation" is not, but should be, made clear in the PCG. There is no reference to any legislative provisions or case law. Any assumption that the risk implicit in a highly diversified parent's 'all-in' cost of borrowing would be exactly the same as the arm's length risk implicit for one particular affiliate or project would be a gross oversimplification. In our view, *Chevron* should not be seen as authority for such a wide-sweeping statement as that contained in para 77. We are very concerned that the Draft, in para 77 and elsewhere, does not give due reference to our transfer pricing rules (and related OECD Guidelines) that stress the importance of applying internationally agreed and accepted methods to assess whether transactions have been priced at arm's length. The heart of this approach is the search for comparable transactions between unrelated parties. The ATO only makes brief references to comparables in paras 16 and 54 of the Draft. We recommend that para 77 of the Draft be substantially reframed to refer to the importance/primacy of comparable data.

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18. *ATO guidance on the* Chevron *case is sought*. Unsurprisingly, we are getting a number of clients wanting to know what the *Chevron* Full Federal Court decision means for existing and proposed debt, and more importantly from their perspective, how the ATO will apply it. We can't recall the last time, if ever, that we have seen such an immediate level of interest and concern about a tax case. The reasons for that level of interest are obvious, but do include the fact that the ATO regularly lists "*Shareholder Debt – transfer pricing / thin capitalisation integrity*" as its No.1 primary focus area in the large corporate group population. This subject is also listed by the ATO as an important issue for large private groups. The issuance of the PCG is not the same as giving an ATO view on the meaning and practical impact of the *Chevron* case. We appreciate that an application for special leave to appeal to the High Court is now in progress. However, we recommend that, in addition to the PCG, the ATO release some guidance (maybe at least a draft or interim Decision Impact Statement (**DIS**) on the Full Federal Court decision) as soon as feasible; preferably with a quick round of consultation before it goes public. We are aware that the ATO practice is that "***Usually** a DIS will not be published until all appeals have ended and there is a final decision. **In some circumstances** we publish an interim DIS*."[1] So, there is definitely scope for the ATO to issue at least an interim DIS on one of the most important Full Federal Court decisions in many years. Amongst other things, it would be helpful for the ATO to explain the basis for the seemingly Chevron-inspired para 77 of the Draft.

19. *Compliance burden*. If finalised in its current form, the Draft will put a considerable additional compliance load and cost on Australian and foreign based companies to collect the required data, on a regular basis, to self-assess their risk levels.

20. *Rise of PCGs and fall of public rulings*. This latest PCG continues a clear trend for the ATO to issue (non-binding) guidelines rather than (binding) public rulings. Whilst some guidelines on some subjects are welcome, we have a general concern with the decrease in recent years in binding public rulings, which actually give the ATO's view on the law, and the increase in guidelines that not only do not bind the ATO, but which are at times difficult to reconcile with the actual law (legislation and case law.)

21. *Lack of safe harbours – why?* Para 20 of the Draft states that the PCG, when finalised, will not constitute a 'safe harbour'. Why this is the case is not made clear. PCG 2016/1 (*Practical Compliance Guidelines: purpose, nature and role in ATO's public advice and guidance*) contains the following:

> *10. A 'safe harbour' may be described as conduct that is taken to comply with a rule or law that might ordinarily apply on the basis of more uncertain standards. Safe harbours are sometimes provided specifically in legislative provisions, or a provision may contemplate the creation of safe harbours by an administrator. **Other safe harbours determined by an administrator may represent practical, purposive interpretation of a statutory provision**.*
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> *11. In appropriate circumstances, such as those described in paragraph 6 of this Guideline, the Commissioner may make sensible resource allocation decisions consistently with safe harbour approaches and express those approaches in practical compliance guidelines. **In such cases, safe harbours can provide additional certainty and compliance savings for taxpayers in the face of provisions that are otherwise uncertain in their application or impose unexpectedly heavy compliance cost burdens. From the ATO's perspective, safe harbours can provide an efficient and consistent means of assessing levels of taxpayer compliance,** allowing the ATO to direct its compliance resources to higher risk areas of the law.* (emphasis added)
>
> And earlier:
>
> *6. Broader guidance can also enable the ATO to communicate how it will sensibly apply its audit resources or provide practical compliance solutions where tax laws are uncertain in their application or are found to be creating unsustainable administrative or compliance burdens in light of, for example, evolving commercial practices.*

[1] Statement on the ATO's website on the page dealing with Decision Impact Statements.

22. In our view, the transfer pricing arrangements for cross border related party loans are a perfect example of the type of situation contemplated by para 6 of PCG 2016/1. It is of great concern to us that taxpayers can be put to the considerable administrative burden and cost of complying with the Draft and end up with no certainty whatsoever. We strongly recommend that the Draft be reframed so as to constitute one/more 'safe harbours' in certain situations, in accordance with PCG 2016/1.

Specific comments

23. *Date of effect*. Para 132 of the Draft specifically sought comments on the proposed date of effect of the PCG, being 1 July 2017; with respect to both existing and newly created financing arrangements (per para 10). Given that the PCG has not been finalised, we recommend that the date be deferred – until sometime after finalisation, so as to allow taxpayers reasonable time to digest the ATO's finalised views and put in place the (potentially considerable) processes and systems to collect the data and complete the analysis required for the risk self-assessment. Ideally, the PCG should only have a date of effect from 1 July next occurring after the Draft is finalised.

24. *Price relative to global group cost of debt, traceable third party debt or relevant third party debt of borrowing tax entity*. This is the first risk indicator listed in the table in para 82 of the Draft and in practice will be of great significance to all inbound and outbound debt. For inbound debt, interest at more than 201 (presumably this should in fact be more than 200) basis points over the cost of referrable debt will be one of only three risk indicators to attract the maximum of 15 demerit points. A borrower will start to accrue demerit points for having a cost of funds more than 50bps higher than the parent's cost of funds, even if that cost of funds had been determined by valid benchmarking, as in fact required by transfer pricing rules, and was based on solid third party comparables. The basis for the margins over the cost of referrable debt specified in para 82 of the Draft is not made clear. It can be acknowledged that in the particular facts and circumstances of the *Chevron* case, and based on the evidence actually adduced by the parties, the judges involved did not find the comparables presented to them as compelling. However, the Draft appears to veer too far the other way and does not give enough prominence to the importance of good-quality comparables, should they be available; and if so, that they should override the rules of thumb in para 82 of the Draft.

25. *Exceptions: wider application needed for securitisation vehicles*. One of the exceptions to the application of the Draft, per para 14(b), is for loans entered into by "*a member of a wholly owned group containing an* ***Australian resident*** *securitisation vehicle (as defined in section 995-1 of the Act)*" (emphasis added). Section 995-1 defines "*securitisation vehicle*" (and not an "Australian resident securitisation vehicle") by reference to the definition in s.820-942. The definition of *securitisation vehicle* in s.820-942(2) does not draw a distinction between residents and non-residents for the purposes of the zero-capital amount rules in Subdiv.820K of the thin capitalisation rules. Accordingly, we recommend that the exception in para 14(b) of the Draft be extended to any securitisation vehicle (resident or non-resident) to which Subdiv.820K has application.

26. *Exceptions: should include insolvency-remote special purpose entities.* Section 820-39 of the Act contains an exemption from the thin capitalisation regime (separate from the zero-capital rules in Subdiv.820K) for certain "insolvency-remote special purpose entities". The same policy rationale should be extended to any such entities for the purpose of the Draft and an exception made accordingly.

27. *White zone inappropriately restricted: to ATO reviews undertaken before publication of Draft*. If a taxpayer is in the "White zone", para 44 of the Draft provides that no further reviews will be conducted. This will only be the case where one of the circumstances set out in para 38 applies. One such situation is where the ATO has conducted a review of a taxpayer's arrangements in the last three years and provided the entity with a risk rating. However, it is made clear in para 38 (per footnote 4 to the Draft) that this outcome only applies where reviews have been undertaken by the ATO *after* the publication of the Draft. No rationale for this restriction is provided. This is administratively unfair for taxpayers who have had reviews undertaken by the ATO *before* the Draft was issued (and issued a 'low risk' rating) and who have relied on this risk rating. In our view, instruments which have been reviewed and risk assessed by the ATO before the Draft was issued should have their assessment 'grandfathered' until either a material change in the terms of the instrument (per para 38(b)), or the maturity of the instrument. For example, we aware of one taxpayer whose (significant) related party debt arrangement has been reviewed by the ATO nearly every year since issue, with a low risk rating being issued. It seems unreasonable that such a

taxpayer will not be considered to be in the White zone as they have not been reviewed post released of the PCG. If the entity had been given a High Risk rating previously, it may have restructured the arrangement as required. Despite those earlier ATO reviews/low risk ratings it is, inappropriately, back to square one as far as the Draft is concerned.

28. *Transitional deal inappropriately restricted: to arrangements still on foot on 1 July 2017*. Paras 69 to 73 of the Draft provide a mechanism for a taxpayer to modify/transition existing arrangements to the Green zone, e.g. by adjusting the pricing on a loan or the level of debt. In such a case, and where the taxpayer has made a voluntary disclosure in relation to back years, the Commissioner will exercise his discretion to remit penalties to nil and the shortfall interest charge to the base rate. However, such an outcome only seems to arise if a loan arrangement remains on foot post 1 July 2017 (being the proposed date of effect of thee PCG) and has been modified. If a taxpayer has gone further than merely modifying the terms of an arrangement, and has actually repaid a loan (before 1 July 2017), *and* has made a voluntary disclosure, it is difficult to see why it should not also obtain the benefit of the discretion to remit penalties and interest as set out in para 70. We recommend that the Draft be amended accordingly.

29. *Inappropriate focus on foreign currency related issues*. We are very concerned with the considerable, excessive and unexplained focus in the Draft on foreign currency related issues that inevitably arise with any cross-border related party financing arrangement. Depending upon the precise fact pattern, it appears that where a taxpayer has used the “wrong” currency (viewed from the ATO perspective) for a related party loan, demerit points can be tripled counted and put the taxpayer well into the Red zone, regardless of the interest rate on a loan. This can’t be a fair or reasonable outcome. As noted earlier, the results of the CTA survey show that operating currency of loans is one of the three drivers for CTA members to be in higher risk zones. Effectively forcing global parent companies to use a particular currency to finance their Australian subsidiaries, so that they can keep out of the ‘danger zones’, fails to take account of the commercial reality that a global parent company will access funds from global operations or the global financial market. Such an approach fails to recognise that it is a normal function for the treasury operations of a global company to take on foreign currency risk in respect of its investments, or choose to hedge against those risks in accordance with its global hedging policies. The Appendix to this letter addresses the application of the foreign currency concept in the PCG in greater detail. As noted earlier, in our view not only does *Chevron* not support certain of the positions taken by the ATO in the Draft, if anything *Chevron* would appear to point in the opposite direction.

30. *Other comments*. Our other observations on the Draft, in brief, are as follows:

i. Leverage of the borrower: 10 demerit points for being above 60% gearing appears to be very punitive. It could be very expensive (or simply not possible) for a taxpayer to address this issue as a pathway to a Green/Blue zone.
ii. Leverage of the borrower: Ideally there should be more ‘grading’ for debt levels rather than just a binary +10 or 0 points.
iii. Risk zone reflects highest risk arrangement for the year (para 27): This approach does not allow for any weighting or recognition that one very small “high risk” arrangement could cause other low risk arrangements all be effectively in the Red Zone.
iv. No “drift” within a range for an indicator (para 34): Not only does the ATO’s proposal seem administratively difficult to “monitor” and enforce, but it seems unreasonable to not allow some flexibility.
v. No possible access to the APA program for Red zone taxpayers (para 48): Footnote 6 provides the rationale for this position as follows: “*The Commissioner does not consider this to be an efficient use of ATO resources as the ATO would need to expend considerable additional effort to properly understand the conditions which exist and other relevant facts and circumstances, without which there is a low likelihood of agreement being reached*.” It seems unreasonable to make a blanket ban on APAs for Red zone taxpayers. Many such taxpayers may end up in the Red zone because of 2 or 3 simple indicators (e.g. because the company is over 60% geared and is using the “wrong” currency). In such a case, it may not be that difficult to “*properly understand the conditions which exist*”, such that the door should at least remain open to the possibility of an APA being available; noting also the statement in para 51 that even for Red zone companies: “*our preference is to work co-operatively with taxpayers to optimize compliance outcomes*.”

vi. Options for resolving disputes (para 65): More clarity is needed in this area. What if a taxpayer has been open, transparent etc, but nonetheless receives a high risk rating. Should this really limit any settlement options?

vii. Level of debt (para 70): Given that the Draft is only addressing transfer pricing and not thin capitalisation, it is not clear why there is any need to refer to the 'level of debt' as well as to pricing.

viii. Amnesty not available for taxpayers with tax losses (para 71): It is not clear why this restriction is in place. In addition, it is not clear why (as outlined in the CTA submission, para 16; Appendix 1) it may be "refined" only for losses derived from certain timing differences.

ix. Sovereign risk (paras 105 to 109): For particular industries, generic calculations for sovereign risk may not be sufficient. For example, mining investments in a country where there is significant risk the local Government may cancel mining leases or take ownership of shares in a foreign subsidiary carrying on mining operations.

x. Treaty disputes and mutual agreement procedure (**MAP**) processes: No consideration is provided in the PCG as regards possible disputes with treaty partners over appropriate transfer prices for related party loans and the implications thereof for a taxpayer's risk profile.

Please do not hesitate to contact the writer, should you wish to discuss any of the issues outlined above or in the Appendix.

Yours sincerely,

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Appendix

Foreign currency aspects of the Draft

1. In our view, there is a considerable, excessive and unexplained focus in the Draft on foreign currency related issues. It is trite that interest rates will vary (amongst many other reasons and factors) depending upon the currency in which a loan is denominated: this is just a basic feature of international finance and non-tax based arbitrage. It is quite another thing to say that there is a risk of incorrect transfer pricing *merely because* of the currency chosen for a loan arrangement, or indeed any other contract. A taxpayer needs to be mindful of ensuring that a correct base rate for the relevant currency is used, when determining the interest rate on a related party loan. However, and given that the Draft is only concerned with transfer pricing and not with other potential tax risks,[2] the chosen currency shouldn't be a "risk indicator", but something to be factored into the appropriate interest rate – in the same way, for example, as the length/maturity of the loan. It is pleasing to note that, in the Draft, the ATO has not identified the maturity profile of a loan as a "risk indicator" for transfer pricing purposes. The same position should apply with currency.

2. Depending upon the precise fact pattern, it appears that where a taxpayer has used the "wrong" currency (viewed from the ATO perspective) for a related party loan, demerit points can be tripled counted.

3. In the case of an inbound loan, a taxpayer can potentially end up with 30 demerit points (and thus be immediately over the 25 point "Red zone" threshold; before considering any other potential risk indicators) even if a loan is AUD denominated and with an interest rate that on any reasonable basis is not problematic (including a rate of zero!) from a transfer pricing perspective.

4. This punitive, and very strange, outcome arises because each of these "indicators" separately carries 10 demerit points in the Related party financing risk indicator guide at para 82 of the Draft:

- Currency of debt is different to operating currency.
- Legal currency (or borrowing currency, that is, as reflected in the terms of the loan) and operating currency are different. Operating currency being the currency actually transferred or effectively provided by the lender to the borrower. (As detailed in para 131(f) of the Draft, this is one of the so-called "exotic features" of a loan).
- Involves an arrangement covered by a taxpayer alert (e.g. TA 2016/3: *Arrangements involving related party foreign currency denominated finance with related party cross currency interest rate swaps*.)

5. We comment below on each of these three indicators.

A. Currency of debt is different to operating currency

6. Para 128 of the Draft states that: "*The operating currency of the borrower is the currency in which it earns the majority of its revenues.*"

7. However, nothing in the Draft seeks to rationalise or explain why a situation where the currency of a debt is different to operating currency should be regarded as a "risk indicator" for transfer pricing purposes, nor are any legal principles or case law referred to by the ATO.

8. At the very least, if this indicator is to be retained, we suggest that it be reframed as follows: "*Currency of debt is different to operating currency* ***and is not AUD****".*

9. It is simply not reasonable for a company operating in Australia, with typically AUD denominated salary and other operating costs to have its transfer pricing risk materially impacted simply because it has borrowed funds from a related offshore party in the legal currency of Australia. The same comment applies to an Australian base company making a loan to a foreign subsidiary.

[2] As noted earlier, para 78 of the Draft makes it clear that the PCG does not set out the approach of the ATO to reviewing other taxation issues that might arise in relation to related party debt including, but not limited to: the application of the debt/equity rules; the substantive deductibility of interest payments or other losses; the application of the thin capitalisation rules; the existence or otherwise of liability for interest withholding tax; or the application of Pt IVA of the Act. It is conceivable that a taxpayer's choice of currency for a loan might be relevant for one or other of these (non-transfer pricing) purposes.

10. There are likely to be all manner of good (non-tax) commercial, cash-flow and financial accounting reasons why a company operating in Australia may wish to denominate its related party debt in Australian currency, regardless of the currency in which it may be earning its revenue.

11. The ATO view seems to assume perhaps that a company should somehow seek to have a “natural hedge” by ensuring that its debt is in the same currency as its revenues and/or that such a situation is “normal” or common practice. There are multiple problems with any such assumption or understanding, especially but not only if the loan in question is AUD denominated:

- Companies are often happy to take foreign exchange or other price/market risks. Some hedge their risks. Some don’t. There can be all sorts of reasons why a company may decide to hedge any particular risk, or to leave the position unhedged. This is unremarkable. In a passage that has often been referred to, the High Court in Ronpibon Tin NL & Tongkah Compound NL v FCT (1949) 78 CLR 47 at p. 60 said:

  > *It is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent.*

  In our opinion, the Commissioner taking issue with an Australian company, for borrowing or lending money in Australian dollars, would seem to be a variation on this theme. As indicated above, in our view the only circumstance where the Commissioner should possibly flag a “risk indicator” is where the currency of debt is different to operating currency and is not AUD. There may still be a very good non-tax reason for such an outcome, but such a situation may deserve some scrutiny by the ATO. For example, and despite what is said in TA 2016/3, it may make sense for non-tax related arbitrage reasons in certain situations/market conditions for a company to borrow in such a currency and then undertake a currency swap or other derivative so as to achieve the same net effect (but more cost effectively) as borrowing in AUD, or in the currency in which the entity earns the majority of its revenues.

- The currency in which a company earns the majority of its revenues may possibly change over time for various reasons including shifts in market practice in the relevant industry and changes in the location of the company’s major customers. As a result, the company may (quite reasonably) not want to lock in a particular currency position by borrowing in only one foreign currency, nor be under some type of tax-related obligation to change the denomination of its borrowings (with attendant and possibly considerable costs and inconvenience) simply because the currency in which it undertakes its sales changes or may change.

- Even if a company is concerned about the exchange risk arising from having its revenues denominated in a foreign currency, there are other ways to effect a hedge, apart from borrowing funds in that same currency. A company may seek to enter into financial derivative instruments (such as forward foreign exchange contracts, currency futures or options) that match anticipated future foreign currency denominated revenues. Such hedging may not only be more targeted and effective (from cost and financial accounting perspectives) than borrowing funds in the relevant currency, but such an approach is more flexible – enabling the taxpayer to more easily switch its hedging on or off depending upon its view of currency movements. Of course, if the company has in fact specifically hedged future foreign currency denominated revenues in such a manner, it would generally make no sense to also borrow in that same currency.

- If a company borrows in foreign currency, it will need to book unrealised gains and losses, on a translation basis, in its profit and loss account for financial accounting purposes on an annual or more regular basis. This may have various adverse consequences (in the case of losses) including but not only the potential breach of covenants on other loans, i.e. from unrelated/third parties.

- A taxpayer may be concerned about potential tax asymmetry on the inevitable gain or loss that will arise where a borrowing is foreign currency denominated. Any gain may be assessable, but a taxpayer may be concerned that a loss (especially if “large”) may be queried by the ATO, on the facts, as not being fully deductible, e.g. if the taxpayer has foreign operations and the borrowings were pooled and used in part to fund Australian operations and in part to fund foreign operations that give rise to non-assessable non-exempt (**NANE**) income.

- There is nothing in *Chevron Australia Holdings Pty Ltd v FCT* [2015] FCA 1092 at first instance, or in the reasons of the Full Federal Court on appeal, in *Chevron Australia Holdings Pty Ltd v FCT* [2017] FCAFC 62, which can reasonably be regarded as supporting the position taken on this issue in the Draft. Further comments on the decisions in *Chevron* are set out below.

B. Legal currency (or borrowing currency, that is, as reflected in the terms of the loan) and operating currency are different

12. It is extremely difficult to see what possible relevance this matter has to the question of the adequacy or otherwise of the interest rate on related party debt for transfer pricing purposes. As with the issue/indicator discussed above, there is nothing in the Draft that seeks to rationalise or explain why this circumstance should be regarded as a “risk indicator” for transfer pricing purposes, nor are any legal principles or case law referred to by the ATO.

13. For the reasons which follow, it is quite concerning that the ATO regards this very common commercial practice as somehow “exotic”, or in any way untoward:

- The indicia of what currency a loan is actually denominated in should be relevantly seen as follows:
  - The terms of the loan/documentation as agreed between the parties.
  - Most importantly: what actually happens upon repayment. This is strongly indicative of which party bore the exchange risk (see example below).
  - Possibly: the base interest rate (if applicable) on the loan. Base rates typically vary as between different currencies at different points in time.

  The currency actually transferred or effectively provided by the lender to the borrower at the start of a loan is a complete “red herring” and is not/should not be regarded as relevant.

- Consider this simple example. Say an Australian company agrees to borrow AUD 100 from its foreign parent. For one or other good reason (maybe one of those noted further below), the parent actually remits USD 70 to the Australian company’s USD bank account, being the-then spot value of AUD 100. In 5 years’ time, the company is due to repay the AUD 100 loan to its parent company. At that time, assume that AUD 100 happens to be worth say USD 100. The company has AUD 100 on hand. It has 2 choices:
  - It could transfer the AUD 100 to its parent.
  - It could use the AUD 100 to buy USD 100 and remit USD 100 to its parent.

  In either case, the Australian company has not borne any exchange risk on the *debt/liability*. It received the *equivalen*t of AUD 100 upon draw down (being USD 70) and either paid AUD 100 or the *equivalent* of AUD 100 upon repayment of the loan. The taxpayer has no currency loss or risk of loss on its *debt/liability.* The fact that it has actually received USD 70 rather than AUD 100 on initial draw down has, and should be seen to have, no relevance for transfer pricing purposes as regards interest payable on the loan. Of course, if the company retains the USD 70 upon drawn down for any length of time before use/conversion to AUD, it may experience foreign exchange gains/losses on those funds (i.e. on the *asset*) which will generally/appropriately be assessable/deductible, unless related to NANE income.

  Say in the above example that the taxpayer drew down USD 70 and immediately acquired AUD 100 which it uses in its business. It pays interest on the loan at an appropriate AUD rate to its parent. In 5 years’ time, the taxpayer uses AUD 100 on hand to buy USD 100 which it remits to its parent in discharge of its AUD 100 loan. What possible “’mischief” or “problem” does the ATO reasonably see with such a fact pattern? What possible bearing do these facts have on the applicable interest rate on the loan for transfer pricing purposes? Would the ATO be prepared to say that the loan was in fact a USD loan and grant the taxpayer an AUD 30 tax deduction upon repayment (USD 100 repayment less USD 70 drawn down translated at the spot rate at the time of repayment)?

- Possible and common reasons why a company might actually receive/draw down funds in a currency (say USD) different to the currency of the loan (say AUD) include but are not limited to the following:
  - In the case of a very large AUD loan, the need to go into the foreign exchange market and acquire all the relevant AUD at one point in time by the parent might actually be so significant as to have an adverse impact on market prices viewed from the lender's perspective. Over the years, we have had a number of clients indicate to us that this is indeed a very significant practical issue that needs to be carefully managed. For example, transferring the funds in USD and allowing the borrower to convert the sum to AUD on a periodic/as needed basis may be less disruptive to market prices and more cost effective.
  - The borrower may actually have an immediate need for USD, e.g. to possibly repay/refinance an existing USD borrowing, or to pay for USD denominated imported trading stock or capital assets. For example, say an Australian company has an obligation to pay USD 70 to a foreign unrelated supplier for the acquisition of machinery. Assume that it makes commercial sense for the company to borrow AUD 100 (worth USD 70) from its parent to fund the acquisition. What possible mischief or problem is there if the parent actually remits USD 70 to the Australian borrower (to avoid the unnecessary hassle and cost of a conversion to AUD by the parent and then immediately another conversion back to USD by the Australian subsidiary), or if the parent actually remits USD 70 directly to the foreign supplier at the direction of the Australian company?
  - Convenience of the parties; especially the lender, who will typically be in the "stronger" bargaining position.
- Again, there is nothing in either decision in *Chevron* which can reasonably be regarded as supporting the position taken on this issue in the Draft.

C. The loan involves an arrangement covered by a taxpayer alert

14. Amongst other things, Taxpayer Alert TA 2016/3 (*Arrangements involving related party foreign currency denominated finance with related party cross currency interest rate swaps*) asserts the concept of a "natural" currency.

15. One of the features identified in TA 2016/3 to be considered in determining whether an arrangement is of concern to the ATO is: "*the 'natural' currency of the Australian entity, i.e. the currency in which it will be earning the revenues to repay the loan*".

16. There is nothing in TA 2016/3 that seeks to properly rationalise or explain the origin or basis for the "natural" currency concept, nor are any legal principles or case law referred to by the ATO.

17. The Taxpayer Alert simply says:

> *"The 'natural currency' of the Australian entity will sometimes be USD, in that:*
>
> > *• the Australian taxpayer entity needs foreign currency, for example, to meet foreign currency liabilities for capital expenditure, working capital or refinancing purposes*
> >
> > *• the relevant operations in Australia generate revenue and cash flows predominantly in foreign currency and this foreign currency is reasonably considered to be the 'natural' currency of the Australian taxpayer entity.*
>
> *Where the natural currency of the Australian entity is instead AUD, depending on the extent of the Australian entity's Australian dollar funding requirements and Australian dollar revenues, the net effect of all the relevant related party transactions is that the Australian entity obtains AUD and/or settles its obligations in AUD*."

18. In our opinion, this notion of "natural" currency in TA 2016/3 suffers from the same defects as the risk indicator *Currency of debt is different to operating currency* in the Draft considered above.

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The decisions in Chevron

19. In *Chevron*, there was much conflicting expert evidence as regards what was or should have been the currency of the actual loan in question, as well as the currency of the hypothetical loan for the purposes of transfer pricing analysis.

20. It was however clear that the borrower regarded itself as having borrowed an amount of AUD, notwithstanding that the lender actually remitted the loan funds in USD:

> "*117. Mr Dalzell said that after the directors of CAHPL approved the Credit Facility, bank accounts were opened with Citibank in the United States for CAHPL and for CAPL in accordance with Chevron group policy and practice. Consequently, on 6 June 2003 CAHPL drew down on the Credit Facility with CFC and a credit of USD1.45 billion was made to CAHPL's Citibank specified account number, and on 26 August 2003 CAHPL drew down on the Credit Facility and a credit of USD1 billion was made to the same CAHPL Citibank account number. Mr Dalzell said that a purchase of AUD3,707 million in Australian currency would have incurred significant bank fees. Interest payments under the Credit Facility were similarly effected through debits to the US dollar bank account. The amounts of the interest payments made to CFC were calculated by reference to the AUD principal amount borrowed, being the AUD equivalent of the aggregate amount of the drawdowns of USD1.45 billion and USD1 billion*."

21. Regardless of the fact that the lender actually remitted the loan funds in USD, at first instance Robertson J said at para 302:

> "***I find that there can be no doubt as to the currency of the Credit Facility, which was in Australian dollars.*** *I consider the issue of the currency of an arm's length loan or a loan between independent enterprises at [583] below*." (emphasis added)

22. Robertson J from paras 476:

> "*476. As to the question of the USD providing a natural hedge against the fact that a considerable portion of the revenue was in USD, Professor Boymal agreed that when he was speaking about a natural hedge he was talking only about a hedge in a commercial sense and not in terms of a technical hedge accounting sense: he was not applying hedge accounting, being a specific method of recording when hedging takes place.*
>
> *477. Professor Boymal also agreed that his opinion as to the natural hedge contributed materially to his conclusion about the selection of USD as the currency of the loan.*
>
> *478. The applicant's submissions in relation to Professor Boymal's evidence were that he was a former accountant but purported to give "commercial" evidence, having never worked for an oil and gas company and thus he did not have sufficient expertise to assist the Court in determining how Australian oil and gas companies should borrow. Also, it was far too simplistic to assume, as Professor Boymal did, that borrowers always borrowed in the currency with the lowest rate. If that were so, then all borrowers would borrow in the same currency. The fact was, the applicant submitted, that the selection of currency was a complex matter and depended on a number of factors, including the denomination of revenues, the denomination of expenses, and the functional currency of the company. It required knowledge of the industry in which the borrower operated, particularly if one was to make an attempt to take advantage of a "natural hedge". The applicant submitted that Professor Boymal attempted impermissibly to reformulate the terms of the loan as his observations in relation to the "optimal currency" of the loan, and his review of the evidence of the lay witnesses, was directed solely to the proposition that arm's length parties would have chosen a different currency. The hedging evidence of Professor Boymal was said to go to a "commercial hedge" rather than hedge accounting. It could not, therefore, touch the issue raised about volatility in the accounts. Nor could it touch the tax issue. And the "commercial" evidence given by Professor Boymal should be given little weight, given that his expertise was in accounting.*
>
> *479. I find that Professor Boymal, as an accountant and with his experience had very limited qualifications to give the evidence in chief which he gave on the question of the optimal currency of the loan. I give his evidence little weight*."

23. At para 583 Roberson J stated:

> "*As to the currency of a loan, although it is not necessary to my conclusion, I am not persuaded that the condition as to the AUD currency which was operational between CAHPL and CFC differed from the condition as to currency which might have been expected to operate between independent enterprises dealing wholly independently with one another. **I accept the applicant's submission in this respect that borrowings in AUD would avoid or limit foreign currency gains and losses**. I am not persuaded Professor Boymal's opinion to the contrary*." (emphasis added)

24. In the Full Federal Court, Pagone J, with whom Perram J agreed, said at para 134:

> "***It is unnecessary to deal in much detail in this case with the difference between the parties concerning the proper currency of the hypothetical agreement to be compared with the actual agreement**. CAHPL submitted that the hypothetical agreement was to be denominated in Australian currency as provided by the Credit Facility Agreement and, incidentally, as the Commissioner had assessed. The evidence, however, was capable of supporting a different reasonable expectation because the funds lent by CFC to CAHPL were wholly sourced from the issue of commercial paper in the United States denominated in United States dollars. Furthermore, all of the funds raised by CFC by the issue of commercial paper were applied in the United States for the United States needs of the Chevron group: the loan between CFC and CAHPL was only an internal transaction. His Honour at [583] accepted, however, that the terms of the hypothetical agreement might have been expected to be in Australian currency. In that regard his Honour accepted CAHPL's submission that its borrowings in Australian currency would avoid or limit foreign currency gains and losses. **His Honour had also said at [302], as was clearly the case, that the actual loan was in Australian dollars**: see also [102], [105], [106], [113], [115] and [116]. **There is no reason to depart from those findings and from his Honour's conclusion that the hypothetical agreement might reasonably have been expected to be in Australian currency***." (emphasis added)

25. In his separate reasons, Allsop CJ was not particularly concerned by the currency issue, simply noting at para 35:

> "*Funds were drawn down in two tranches, on 6 June and 26 August 2003. I will treat the receipt of funds in Australian dollars*."

26. In short, nothing in any of the decisions in *Chevron* supports the views taken by the ATO in the Draft on the relevance or importance of foreign currency issues as risk indicators for the transfer pricing implications of related party loans. Indeed, in our view, not only does *Chevron* not support certain of the positions taken by the ATO in the Draft, if anything *Chevron* would appear to point in the opposite direction.