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Précis Paper

Transfer Pricing and Cross-Border Financing Part I

A discussion of the significant recent decision in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62

Discussion Includes

- **The facts**
- **Tax consequences**
- **Expert evidence**
- **Core tax principles**
- **Threshold**

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Transfer Pricing and Cross-Border Financing Part I

In this edition of BenchTV, Chris Kinsella (Partner – MinterEllison, Sydney) and Michael Clough (Partner – King & Wood Mallesons, Melbourne) discuss the recent landmark decision in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 6, why it has gained significant international attention and the implications of the decision for tax law in the future.

The facts

1. **This case has been described by the Commission of Taxation as probably being the most important tax case in Australia, ever. In effect, this decision is the third material tax case in Australia on transfer pricing. Notwithstanding that for over 30 years in Australia there has been transfer pricing provisions in the Australian tax legislation, there has been a porosity of case law dealing with transfer pricing.**

2. **The two earlier transfer pricing cases, *Roche Products Pty Limited v Commissioner of Taxation* [2008] AATA 639 and *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74 were both cases where the tax payer was ultimately successful. However, in this case, *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62 (*Chevron)*, the Commissioner of Taxation was ultimately successful.**

3. **In *Chevron,* Chevron Australia merged with Texaco in 2000 and as a result, the combined balance sheet had a large surplus capital. Chevron returned this capital to the United States and needed to refinance that amount of money it had previously sent back, and did so by way of an internal loan. Chevron Australia then sought to refinance that loan which was approximately $3.8 billion.**

4. **Chevron Australia decided to refinance the loan through a structure which involved borrowing from the United States Commercial Paper (USCP) market. This structure effectively meant that withholding tax was not payable on any interest on that $3.8 billion loan. Chevron Australia set up a subsidiary, Chevron Texaco Funding Incorporation, which issued the paper to the CP market, but in order to do so the CP market required a guarantee from the ultimate Chevron parent, known as CVX.**

5. **Chevron Texaco Funding Corporation, after having borrowed from the market USD 2.5 billion, then on-lent that figure to the Australian operation in the AUD equivalent. The currency of the transaction, USD, gave rise to the loan between Chevron Texaco Funding Corporation and its parent, Chevron Australia. However, the loan itself was documented in AUD equivalents, and the obligations to pay interest, and to pay on maturity the balance**

owing, were defined in AUD amounts, meaning that ultimately the Australian parent borrower was obligated to make all payments in Australian dollars.

6. This led to a situation where, at the relevant time, and because of the relativities between the AUD and the USD, and their relative interest rates, the Chevron Texaco Funding Corporation made a significant cash profit. With the benefit of the CVX guarantee, the rate of interest payable by Chevron Funding Corporation in the USCP market was very low.

7. Chevron, at the time, took some sounding from international banks as to what an appropriate rate would be for the AUD loan, and there was a significant difference in the cash margin (roughly 400 basis points). The fundamental issue, at least at first instance, was whether the correct percentage of mark up on that loan was 400 basis points.

8. The Commissioner wanted to focus upon whether or not the currency to be taken into account for the purposes of the transfer pricing provisions ought to be in USD because Chevron borrowed in USD, and the markdowns were done in USD, but the loan agreement was nominated in AUD. There was, in effect, a 9% rate being charged by the US special purpose subsidiary to Chevron Australia.

Tax consequences

9. Chevron Australia was claiming a 9% interest deduction based on the AUD loan, therefore no withholding tax was payable because of the exception in s 128F of the *Income Tax Assessment Act 1936* (Cth), This is a provision that is designed to permit Australians to borrow capital from overseas.

10. The Chevron Funding Corporation, being a US corporation, was consolidated into the Chevron US tax return and the income was recognised for US tax purposes, but Chevron Australia, because of the way the US tax system works, is also consolidated into the US tax return, so it receives a deduction for the interest.

11. Due to the way the currencies moved against each other at the time, the funding subsidiary made a significant foreign exchange gain over time, and that profit was remitted to its parent, however those remittances were not subject to Australian tax effectively because they fell under s 23AJ of the *Income Tax Assessment Act* 1997 (Cth) which, in those days, exempted dividends from foreign subsidiaries.

12. The Commissioner saw what was a one sided deduction, in circumstances where the global group was borrowing in USD, but the Australian group was effectively getting a 9% tax deduction. Due to the way s 23AJ of the Act worked, any profits that were made by the

funding subsidiary were returned as cash to the Australian parent, so that on its face it looked like there was a refund of some of the interest.

13. The Commissioner challenged the structure used by Chevron on transfer pricing. It is often wondered why the structure wasn't challenged by the Commissioner through the general anti=avoidance provisions in Part 4A. The structure used was essentially designed to avoid withholding tax. For the time period applicable to this case, the avoidance of withholding tax was not a tax benefit within the meaning ascribed to it in Part 4A, but now it is. The borrowing in AUD was for a good commercial reason. The trial judge found in favour of Chevron, and for Part 4A to apply, a different finding would have had to have been made. Ultimately, if the parent company had lent in AUD, the only issues would be whether or not the loan denominated in AUD itself is an objectionable tax feature, or alternatively, whether the rate is too high. There is a potential cross over between transfer pricing and Part 4A, but it was not dealt with in this case.

<u>Expert Evidence</u>

14. In this case there was in excess of 20 experts, with about 30 export reports covering things such as credit ratings, accounting, economy, transfer pricing, international law, banking, etc. This case displays the importance of expert evidence, however in this case every one of these experts was rejected or otherwise found to not be wholly reliable for a variety of reasons.

15. Expert witnesses are particularly important for tax payers as it is the tax payers that carry the burden of proof in these sorts of cases. There were so many expert witnesses due to the fact that there was no case around the world yet that interpreted the international standard through the Organisation for Economic Co-operation and Development treaties of the arms-length principle when it comes to a loan from a parent to a subsidiary, especially where different currencies are involved.

16. As this was the first case, the Commissioner ran a number of arguments in the alternative. Firstly, that it was a USD loan, and secondly, he provided evidence regarding what comparable companies would have done commercially in the circumstance. There was some arguments about what the US law was, and there was the question of how one should determine what the rate for pricing should be. One competing argument was that you did a shadow rating, so both parties had experts relating to this issue. An alternative way of pricing it was to use transfer pricing economists, an industry which is well known and accepted in the United States.

17. Instead of using so many expert witnesses, one approach could have been to ask the trial judge to make preliminary findings of fact, but given that this was the first case in this area, the trial judge was not comfortable making preliminary findings.

Core tax principles

18. The *Chevron* case involved 5 income years, 5 of which involved a now repealed transfer pricing provision in Division 13 of the *Income Tax Assessment Act 1936* (Cth), and 3 of the 5 years involved a then new sub division introduced into the Australian legislation in 2012, sub division 815A. Both Division 13 and subdivision 815A are no longer in the Australian legislation. We now have subdivision 815B which is closer in its wording to 815A, than it is to Division 13.

19. On the issue of statutory interpretation, the trial judge Robertson J said that there is no substitute for reading the words of the legislation. However, the Chief Justice of the Federal Court of Appeal stated that in the context of the transfer pricing provisions and what they are aiming to do, a degree of flexibility is required around the interpretation of those provisions. High Court cases such as *Project Blue Sky v Australian Broadcasting Authority* (1998) 194 CLR 355 and *CIC Insurance Ltd v Bankstown Football Club Ltd* (1997) 187 CLR 384 require you, in certain circumstances, to look at the context.

20. The difficulty that comes from the question of statutory interpretation is two-fold. The first is, the High Court themselves have often said it is very difficult to work out what the policy behind any tax provision is because there are so many contradicting provisions in the Act. In this case, you have thin capitalization which is supposed to have safe harbours in it, yet through the transfer pricing provisions you price on the basis that they don't necessarily apply. Secondly, there is what is known as the concession to lift the rate to the actual excessive debt. It is difficult to understand the policy behind the provisions if one is led to the conclusion that in the circumstances, you can say that the arms-length principle involves the subsidiary borrowing with a parent company guarantee.

Threshold

21. There was a threshold issue pre-*Chevron* where a question arose as to whether Division 13 was a provision that enabled the Commissioner to alter the price of the property supplied or acquired, but nothing more. In the context of a loan agreement. The question must be asked as to whether the Commissioner and the Court must accept the terms, conditions, covenants, etc. of the loan for what they are, and whether the arms-length interest rate should be determined on the basis of what the parties actually did.

22. Under Division 13, the question must be answered by reference to the transaction base, i.e. you look at the transaction that was actually done and you price that transaction. The trial judge took the approach that he would follow this, but will adjust it to the extent necessary in the circumstances, based on the evidence before him that he has accepted, to make the provision work.

23. Chevron's principle argument was that if it does not fall foul of any of the specific provisions, or Part 4A, then all that is left to do is price what happened. If there is something about the terms of the loan that are considered objectionable from a tax perspective, and are driven by tax, that is for another provision or Part 4A.

24. Division 13 replaced a profit based provision which was thought too difficult to administer, so Division 13 is based upon what price has been done. In the first instance trial, this led to a focus on the property which was a fundamental element of the interpretation of Division 13, and raised the question of whether the property was in fact done (the loan), or was it something else? The Commissioner responded to that by stating that the property was US dollars, and secondly the property was not what was, in fact, done. Chevron was asking for the Court to make a decision on the price based on what was in fact done, but the Commissioner was asking for a price based on adjusted terms.

25. Robertson J held that some of the covenants and security that would be expected to be seen in an arms-length dealing were not in place on this particular loan. Robertson J was able to use the lack of covenants and security as supportive of his reasoning that the actual consideration did not match an arms-length consideration. Unsecured loans are more expensive than secured loans, so is what is being compared here the total actual consideration with the total arms-length consideration, or is it different components? The trial judge lifted terms and conditions, particularly where they involved something provided by the borrower to the lender, out of property and put them into consideration. This supported his finding that Division 13 could apply to adjust the consideration that was provided downwards.

26. On the issue of subdivision 815A, the provision is quite different from Division 13. Subdivision 815A has a focus on conditions and there were various conditions listed in the judgement where there were, arguably, differences between what would have been done at arms-length and what was done. The trial judge found that there seemed to be a difference between what would have happened at arms-length, and what actually happened. As the trial judge found in favour of the Commissioner on the Division 13 point, after outlining the conditions he accepted as non-arms-length conditions, the analysis stopped there

BIOGRAPHY

Chris Kinsella

Partner – MinterEllison, Sydney

Chris Kinsella is a partner at MinterEllison with a focus on tax controversy matters. He has acted for many Australian taxpayers and multinationals, particularly in the financial services sector. He was the instructing solicitor for the Australian Taxation Office in its transfer pricing dispute with Chevron. Chris has represented both taxpayers and the ATO in tax disputes – specifically tax audits and tax litigation. Chris has practised in tax since the early 1980s in Australia, the UK and Singapore. Chris is listed as a leading tax lawyer by Chambers and by Best Lawyers.

Michael Clough

Partner – King & Wood Mallesons, Melbourne

Michael Clough is a partner at King & Wood Mallesons where he specialises in income tax issues which arise in the domestic and international capital and debt markets and M&A transactions. Chambers Global has recognised Michael's 'leading tax disputes practices with significant experience in the Supreme, Federal and High Courts, acting for many of the largest corporations in Australia in high profile cases'. Specifically, his work includes all aspects of tax audits and litigation, such as negotiations and actions in relation to the collection of tax, access to premises, production of documents and tax appeals generally. Michael was also recently voted Tax Partner of the Year 2016 by Lawyers Weekly. Michael has been a Visiting Fellow at the University of Melbourne lecturing in International Tax Law in the Masters of Laws programme.

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