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Précis Paper

Transfer Pricing and Cross-Border Financing Part II

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

Discussion Includes

- **Currency**
- **Implicit support**
- **Arms-length guarantee**
- **Future implications**

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Transfer Pricing and Cross-Border Financing Part II

In this edition of BenchTV, Chris Kinsella (Partner – MinterEllison, Sydney) and Michael Clough (Partner – King & Wood Mallesons, Melbourne) continue to 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 this decision for tax law in the future.

Currency

1. **The borrowing by the subsidiary was in USD, but the on-lending to Chevron Australia was expressed to be in AUD. The Commissioner argued that the funds advanced were USD, the revenues of Chevron Australia were predominately in USD (88%), that it was a wholly owned subsidiary that had borrowed in USD on an accounting consolidated group concept, the Australian group, which includes the US borrower, had borrowed USD, and had USD revenues. This is one area where the Commissioner did not have the support of the Court overall.**

2. **The US subsidiary, formed wholly for the purpose of going to the US Commercial Paper market, borrowed USD, so the Commissioner advocated that if this loan had been done on arms-length terms, it would have been USD rather than AUD. In the Practical Compliance Guideline 2017/D4, the Commissioner still believes that the chosen currency of the loan is a factor he will consider from a transfer pricing perspective.**

3. **The essence of Chevron's argument in this respect was that the Commissioner is not entitled to decide that the thing to be priced is a USD loan, because it was not a USD loan, it was an AUD loan. Chevron also argued there were good commercial reasons for entering into an AUD loan.**

4. **There was a lot of time and thought put into the question of whether the transfer pricing provisions can impact the choice of currency of a loan by a tax payer, and is it permissible for the Commissioner to come back and say that they borrowed in USD? Ultimately in this case, the trial judge found that there were good commercial reasons for borrowing in AUD. The evidence was basically that AUD borrowings were the currency of account for accounting purposes and also the currency of account for tax purposes.**

5. **Part of the submission from the Commissioner was that the funding subsidiary of Chevron Australia that borrowed in USD and on-lent in AUD, because it was part of the accounting consolidated group, the consolidated accounts would net out and there would not be any foreign exchange exposure there. This still meant that the parent company would potentially, as a single legal entity, incur both foreign exchange gains and losses.**

6. Previously an Australian company had no choice but to file a tax return in AUD, and convert all foreign currency transactions into AUD at the relevant transaction date. That has changed, and where the auditors permit a company to change its currency of account for accounting purposes to a foreign currency, and other conditions are satisfied, our legislation now enables Australian companies to change their currency of account for tax purposes.

7. Although the rules allow you to change functional currency, they only allow you to do so if there is a trigger event, something of significance, a change in your operations, etc. This change is not an election, you either have to change or you do not have to change. There is a reconstruction power in subdivision 815B, s 815.30 of the I*ncome Tax Assessment Act 1997* (Cth), but this reconstruction power is untested as there was no equivalent provision in Division 13 or in subdivision 815A.

8. In dealing with loans, one of the things that must be taken into account is who takes the risk. If the loan is in USD, and you want to change it to USD, or vice versa, you have changed the risk that the borrower and the lender are taking on. The taxpayer is Chevron Australia, which means Chevron Australia is the entity that determines the margin that is applicable on the loan because they are the borrower.

<u>Implicit Support</u>

9. The Commissioner argued that just because there is not a specific guarantee in place, it is possible and reasonable to impute implicit support. The issue was put before the trial judge and there were ratings experts for both Chevron and the Commissioner, who reached different conclusions. Chevron's expert said the concept of implicit support, if it applies, is one that is good for an uplift in credit rating notching.

10. The Commissioner's expert, on the other hand, said that implicit support has regard to the degree of quantitative and qualitative affiliation, and integration of the two operations. In this case, the Chevron Texaco Funding Corporation is a material wholly owned subsidiary, using the Chevron name, in the same industry, and so on. The expert argued the subsidiary is integral to operation of Chevron the global multinational corporation, and in those circumstances, the degree of quantitative and qualitative integration is strong, so notching up is permitted to something at, or near, the credit rating of the US. The Commissioner's team argued that it was not appropriate to pretend that Chevron Australia is an oil and gas company because that is not the case – it is a wholly owned subsidiary of a US oil and gas super major.

11. **Chevron, at essence, argued that the tax payer was Chevron Australia and there was no guarantee from the parent company. The Commissioner argued that the tax payer is Chevron Australia, and it is a wholly owned subsidiary of an oil and gas super major, and it would be unrealistic to sheer that affiliation away.**

12. **Applying the no arms statement provided in *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74 to Chevron Australia meant that one looked at Chevron Australia with no support from the parent. Any support from the parent would have come in at arms-length terms. So if it was implicit support, you would have to charge for it as if it was an external guarantee, otherwise you are infringing the arms-length principle.**

13. **On the other hand, you have the approach provided by *General Electric Capital Canada Inc v The Queen* [2009] TCC 563 (*GE Canada)* which basically states that in these circumstances, you determine that Chevron Australia is borrowing, but in coming up with what is an arms-length consideration, you look at what it would have paid had it borrowed from a third party lender. In this sense, you must identify whether the arms-length lender would have been a banker as the trial judge found, or whether it was the CP market. The banking evidence was that implicit support would always be taken into account, but not account for very much when you get into the billions of dollars – it may influence you to lend to the subsidiary, but would not have a great effect on depressing the price of the debt.**

14. **On the basis of the decision, both at first instance and in the Full Court, it would be fair to say that you may expect in future that you would assume the loan is from a third party, following the *GE Canada* approach. However, the implications of the pricing support depend very much upon the circumstances and the facts of the case. The orphan theory that Chevron put forward in this case was unsuccessful.**

15. **To the extent to which the ruling in *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74, which the trial judge distinguished on the facts, is taken to mean that you cannot look to the fact that an Australian company is owned by a foreign parent. Robertson J found that you can have regard to implicit support as a matter of law, and you can say that Chevron Australia is owned by an oil and gas super major. Pigone J held in the Full Court that there probably would have been a guarantee, but he also said that the US funding subsidiary would not have paid a guarantee fee, and he found no evidence of the payment of a guarantee fee.**

16. **The Full Federal Court was prepared to infer that guarantee would have been provided in an arms-length situation but they were not prepared to go the next step and infer that if it was an arms-length guarantee, that there would have been an arms-length guarantee fee**

for it. His Honour made it clear that it would be unsurprising if a guarantee fee would be charged in a transaction between arms-length parties.

17. The Organisation for Economic Co-operation and Development Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (2017) make it clear to expect an arms-length guarantee fee to be paid, and it is becoming more common to require an arms-length guarantee to be paid. Subdivision 815A referring to conditions also refers to 'an amount of profits' not brought to tax as a result of actual considerations being different from arms-length considerations.

18. There was an argument by Chevron that all profits ultimately came back by way of dividends back to Chevron Australia. On this point the Court was not prepared to find in favour of Chevron on a subdivision 815A issue because the dividends came back to Chevron Australia. Given that subdivision 815A is effectively an enactment of the treaty, it comes down to how you interpret treaties. Different countries have different views on how treaties are to be interpreted.

<u>Arms-length guarantees</u>

19. Under Division 13, in determining what the arms-length consideration would have been in those circumstances, one may take into account the consideration which moves from the parent to the lender (i.e. the guarantee). It is very difficult to understand why the Commissioner is not entitled to deal with loans where some of the conditions of the loan make it clearly more expensive than if you had what might be considered true independent arms-length conditions existing.

20. In those circumstances where you are imputing the guarantee into the transaction, you may say all subsidiaries borrow at the parent rate. In the circumstances, the actual borrowing by Chevron Australia, on the facts, was in fact guaranteed by the parent because the borrowing subsidiary was owned by Chevron Australia, so therefore you can say that the actual transaction itself was guaranteed by the parent.

21. You will never be able to show, at least for the really big loans, what an arms-length guarantee fee would be because nobody guarantees these loans. In big ticket financing, each financing is unique - they are tailored, structured, highly sophisticated products bearing on the characteristics of the borrower, and possibly the lender. One would have thought finance or borrowing money would be the easiest thing in the world to price as it is the most fungible thing in the world, and people deal with billions of dollars all the time. However, the fact patterns make it very difficult, especially the bigger, or the more unusual the transaction.

22. Ultimately Chevron Australia lost the case as they did not discharge the onus of proof, which raises the *Dalco* issue. The Chevron case was run in the years when the provision about objections only required you to show that the assessment was excessive. The case of *Commissioner of Taxation v Dalco* [1990] HCA 3; 168 CLR 614 provides that not only do you have to show that the assessment is wrong, but you must show what the right answer is. The provisions that now exist in the *Taxation Administration Act 1953* (Cth) enacted these words, so a taxpayer now has to prove not only that the Commissioner's assessment is wrong, but what is the right answer.

23. On one view, at least at the trial level, it was quite clear that the assessment was wrong because the Commissioner assessed it based on the AUD loan, but with reference to the parent company borrowing rate. On the trial judge's finding, that was clearly wrong but it could not be proved, to the satisfaction of the trial judge, what the correct answer was. The Full Court took a different approach all together so this issue was not as clear.

<u>Future implications</u>

24. The significance of this case, and the interest from it globally has surrounded the issues discussed above. The issues are, in a sense, universal, despite them being specific to Australian legislation. There were other points raised in this case that have not been discussed, but ultimately they were not central to the case as the case was decided in favour of the Commissioner.

25. In the new Practical Compliance Guidelines 2017/D4, there will be two tables, one for inbound loans and one for outbound loans. These tables will give the loans scores, and if the score ends up in the 'red zone', the Commissioner will investigate. However, you will have an opportunity to come forward and rectify any issues, and will be afforded the opportunity to negotiate in relation to past years in circumstances where the Commissioner is willing to have a discussion around penalties and interest which would otherwise be applicable.

26. The Commissioner will look at the price of the loan relative to global group cost of debt, relative to traceable third party debt, and relative to third party debt of the borrowing third party entity. The Commissioner will also look at the leverage of the borrower, the interest coverage ratio, collateral, subordinate or mezzanine level debt, the headline tax rate of the lender entity jurisdictions, the currency of the debt, whether one party is a hybrid entity and the sovereign risk of the borrower entity.

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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