Australia

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Singapore Telecom Case – Reconstruction Powers in Transfer Pricing

This article discusses the Federal Court decision in *Singapore Telecom* and two other recent judgments that highlight the issue of reconstructing business dealings under arm's length conditions in cases of intercompany cross-border arrangements.

1. Introduction

Three recent cases on transfer pricing in Australia have highlighted the dilemma faced by the courts in reconstructing the hypothetical dealings under arm's length conditions in cases involving intercompany cross-border funding arrangements. The Federal Court decision in *Singapore Telecom Australia Investments Pty Ltd. v. Commissioner of taxation (Singapore Telecom)*[1] is the latest. The extent to which the Commissioner is permitted to go in reconstructing dealings the parties have entered into in order to implement the transfer pricing provisions in the law and arrive at the arm's length position, has again highlighted the complexity surrounding it, in no way providing certainty to multinational businesses modelling their financial structures, especially multinationals using their subsidiaries in cross-border funding. Consequently, such multinationals will continue to confront uncertain arm's length hypotheticals and consequently adverse tax outcomes.

The pivotal facts in cross-border funding are usually the same with only minor deviations. A subsidiary lends funds to its holding company across the border, holding company deducts interest and the tax authorities in its resident country disagree with the amount of interest deducted because of the transfer pricing provisions and the relevant double tax agreements. Australia has also had its fair share of such cases.

2. Statutory Provisions on Transfer Pricing

In order to align Australia's transfer pricing rules with the OECD Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), the transfer pricing provisions found in the earlier version of the rules in Division 13 of the Income Tax Assessment Act 1936, as amended (ITAA 36), were enacted as Subdivisions 815-A, B and C in the Income Tax Assessment Act 1997, as amended (ITAA97). These provisions were made applicable retrospectively from income years commencing on or after 1 July 2004. Unlike under Division 13, the new rules are self-executing in that the taxpayer is required to ascertain whether its dealings do not violate the applicable transfer pricing rules and the Commissioner is still required under the law to make a determination that there had been a transfer pricing benefit accruing to the taxpayer. An account of the relevant provisions is given below.

Section 815-115 of the ITAA 97

This section is modelled on article 9 of the OECD Model ("Associated Enterprises") which reads as follows:

> Where … conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not accrued, may be included in the profits of that enterprise and taxed accordingly.

Section 815-120 of the ITAA 97

A transfer pricing benefit is assumed to be obtained if:
- the entities to an arrangement have "commercial and financial relations";
- the benefit arises from conditions that operate between the entities in connection with those relations (the actual conditions);
- the actual conditions differ from the "arm's length conditions";
- the "actual conditions" satisfy the "cross border" test; and
- if the arm's length conditions had operated:
  - the taxable income for an income year of the entities would have been greater, or
  - their losses for an income year would have been less, or
  - their tax offsets would have been less, or
  - the withholding tax payable by them would have been greater.

Section 815-125 of the ITAA 97

"Arm's length conditions" are defined in this section. It also contains circumstances to be considered when identifying arm's length conditions in the circumstances, such as the functions performed, assets used and risks undertaken by the entities.

Section 815-130 of the ITAA 97

According to this section, identification of the arm's length conditions must be based on the commercial or financial relations between the entities in connection with which the actual conditions operate.

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1. AU: FCA, 17 Dec. 2021, *Singapore Telecom Australia Investments Pty Ltd v. Commissioner of Taxation* [2021] FCA 1597, available at http://www.austlii.edu.au/cgi-bin/viewdoc/au/cases/cth/FCA/2021/1597.html?context=1;query=Singapore%20Telecom%20Investments;mask_path= (accessed 30 Mar. 2022).

815-135(2) of the ITAA 97

This section deals with documents that will assist in the determination of the arm's length conditions. The documents covered by this section are:
– the OECD Guidelines, as approved by the Council of the OECD and last amended on 19 May 2017; and
– a document, or part of a document, prescribed by the Regulations for the purposes of paragraph (2) of section 815-135.

3. Recent Case Law

It is not surprising that the tax community looks to court decisions for discerning the pattern of judicial direction on the issue of determining arm's length hypotheticals. Unfortunately, and yet understandably, such judicial precedents have been mixed in their nature.

3.1. *Chevron* case

The Full Federal Court decision in *Chevron Australia Holdings Pty Ltd v. Commissioner of Taxation*[2] set a clear pathway to the reconstruction powers of the Commissioner. Basically, the essence of the case was the Commissioner contending that the interest paid by an Australian company to its US related company was greater than what an arm's length payment would have been.

The facts of the case, in short, were the following:
– Chevron Australia Holdings Pty Ltd (CAHPL) owned Chevron Texaco Funding Corporation (CFC) and Chevron Corporation (CVX) was the common parent of both CAHPL and CFC;
– CAHPL borrowed funds from CFC, the amount of debt and interest rate payable were determined by CVX. The funds were borrowed from a third party by CFC at a lower rate than that charged to CAHPL;
– CFC borrowed funds supported by a parent guarantee from the Chevron group; and
– the sole reason for the formation of CFC was to raise funds to on-lend them to CAHPL.

Amended assessments were issued on CAHPL on the basis that the interest paid by it on the loan from CFC was greater than it would have been under an arm's length dealing between independent parties.

The Full Court decided that:

> The evidence before, and found by, His Honour amply supported His Honour's prediction of reasonable expectation of a borrowing by CAHPL being supported by security. Its subsidiary, CFC, had borrowed on the market by issuing its commercial paper with a guarantee from its ultimate American parent. It was Chevron policy that CVX in California ultimately decided all matters concerning internal restructures including the extent to which subsidiaries were financed by debt or equity. The policies of Chevron were that no external financing could take place unless Treasury or CVX or another department of CVX approved of the borrowing."[3]

The amended assessments were upheld by the full court.

2. AU: FCAFC, 21 Apr. 2017, *Chevron Australia Holdings Pty Ltd v. Commissioner of Taxation* [2017] FCAFC 62, Case Law IBFD.
3. Id., para. 132.

3.2. *Glencore* case

In *Glencore Investment Pty Ltd v. Commissioner of Taxation*,[4] Cobar management Pty Ltd (CMPL), a wholly owned Australian subsidiary of Glenmore Investment Pty Ltd (CIPL) that was managing copper mining at a mine acquired by the Glencore Group, sold copper to Glenmore International AG (GIAG), the ultimate Swiss parent.

In 2007, the pricing formula, which was based on a market benchmark system was changed to a price-sharing system. Accordingly the price was to be 23% of the selected copper reference price.

The Commissioner did not agree with this change as reflecting the arm's length price. Amended assessments were issued on the basis of increased consideration to be paid to CMPL. Objections to the amended assessments were rejected by the Commissioner, and GIPL, its ultimate Swiss parent, appealed to the Federal Court.

The Federal Court did not agree with the Commissioner:

> … any restructuring of the actual agreement for the purposes of the comparative analysis is limited to the two exceptional cases outlined in the 1995 Guidelines, each being instances where the form of the transaction adopted by the parties "rather than be determined by normal commercial conditions... may have been structured by the taxpayer to avoid or minimise tax".[5]

The two exceptional cases in the OECD Guidelines are:
– where the economic substance of the transaction differs from its form; and
– where, while the form and substance are the same, the arrangements differ from those that 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.

Importantly, in paragraph C.1.38 the OECD Guidelines state:

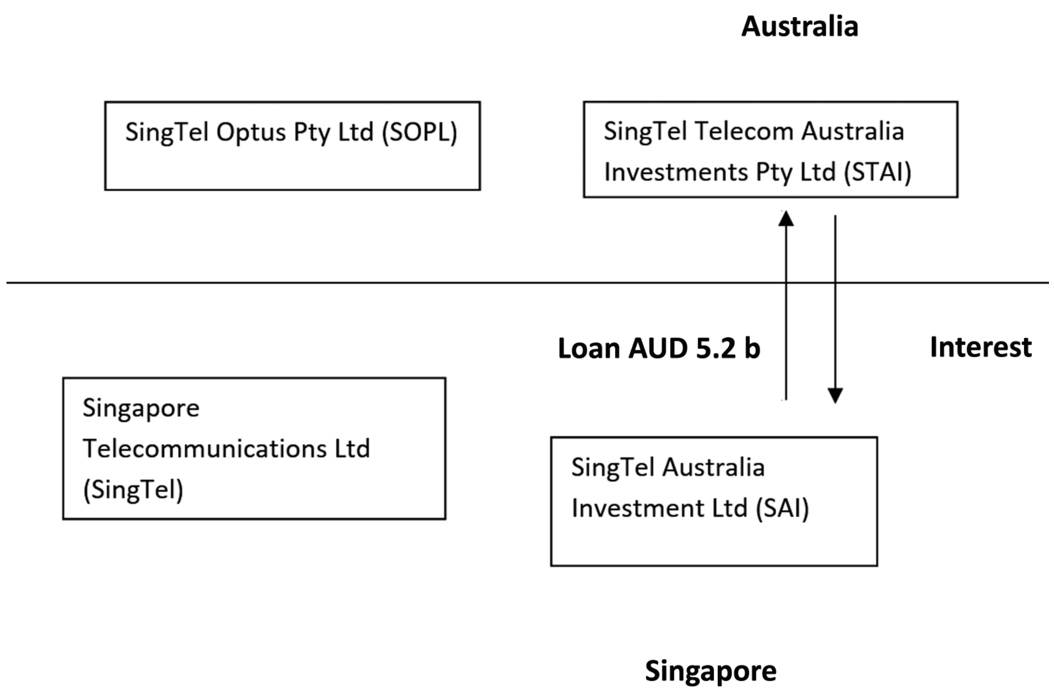
> In both sets of circumstances described above, the character of the transaction may derive from the relationship between the parties rather than be determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimize tax. In such cases, the totality of its terms would be the result of a condition that would not have been made if the parties had been engaged in arm's length dealings.
>
> This paragraph makes it clear that any restructuring of the actual agreement for the purposes of the comparative analysis is limited to the two exceptional cases outlined in the 1995 Guidelines, each being instances where the form of the transaction adopted by the parties "rather than be determined by normal commercial conditions …. may have been structured by the taxpayer to avoid or minimize tax".

The Court agreed that two pricing methods, the price-sharing and the market-related methods were commonly used in agreements for sale of copper in markets everywhere.

On the matter of reconstructing, the taxpayer argued that the Commissioner's approach, rather than pricing

4. AU: FCA, 3 Sept. 2019, *Glencore Investment Pty Ltd v. Commissioner of Taxation of the Commonwealth of Australia* [2019] FCA 1432, Case Law IBFD.
5. Id., para. 317.

Figure 1



the copper as sold under the actual agreement that was in place between the related parties, required the Court to engage in the speculative task of re-imagining all the terms of the contract to which independent parties might be expected to have agreed. The Court supported the view of the taxpayer and stated:

> In my opinion, the Commissioner's approach impermissibly restructures the actual contract entered into by the parties into a contract of a different character.[6]

It was also concluded by the Court that this was not a case falling within the two exceptional cases referred to in the OECD Guidelines.

On appeal, the decision of the Federal Court was upheld by the Full Federal Court. However, it did not agree with the Federal Court that the Commissioner was "impermissibly restructuring the contract" but held that the Commissioner could substitute terms that resulted in a different formula or a different methodology to be utilized in order to ascertain the arm's length consideration.

3.3. Singapore Telecom case

The facts of the case can be summarized as in Figure 1.

In June 2002, Singapore Telecom Australia Investments Pty Ltd (STAI) (Australian company) acquired all the shares in SingTel Optus Pty Ltd (SOPL) for AUD 14.2 million, from its immediate parent SingTel Australia Investment Ltd (SAI). The purchase was funded by the issue of STAI's ordinary shares and a AUD 5.2 billion of loan notes to SAI. The interest payable on the notes was set at a floating rate of 1 year bank bill swap rate (BBSW) + 1.00 per cent. It was also provided that the withholding tax (10%) payable on the interest payment be grossed up. The loan had a maturity date of no later than the tenth anniversary of the issue date of the loan notes.

Subsequently there were three amendments made to the loan agreement:

– First Amendment (31 December 2002): the maturity date was brought forward;
– Second Amendment (31 March 2003): the accrual and payment of interest were altered to be dependent on the financial performance of SOPL, the ultimate parent (Singapore company). The interest rate was increased by 4.552%. The amendment was to take effect from June 2002;
– Third Amendment (30 March 2009): the interest rate was changed to a fixed rate of 6.835% plus 4.552% from the second amendment effective from June 2002. Grossing up continued to be applied.

The amendments made to the loan notes resulted in a total interest payment of AUD 4.9 billion, which was claimed as deduction by STAI. The Commissioner disallowed a part of the interest claimed on the grounds of transfer pricing.

The Commissioner's primary case was based on expert evidence examining a number of alternative scenarios. The Court referred to the following scenarios in paragraph 165 of its judgment where it declared that STAI could have entered into the two following financing arrangements that in the end would have satisfied the arm's length principle:

– it could have issued a bridging loan facility of AUD 5.2 billion for the first nine months from an Australian bank. The facility would be refinanced on 31 March 2003 (the date of the second amendment) with a long-term USD bond (swapped into AUD). Inter-

6. Id., para. 314.

est would be neither deferred nor contingent. There would be no change on 30 March 2009, the date of the third amendment (principal amount); or

– it could have provided an AUD 1.5 billion medium-term revolving facility to cover regular payments of interest on the principal amount. There would have been no need to restructure the loan to accommodate the financial performance of SOPL.

In the alternative, the Commissioner's secondary case was based on the assumption that the last two amendments did not take place and consequently the interest rate agreed in the original loan notes would be applicable and deductible to STAI.

The Court decided in favour of the Commissioner on his secondary case but went on to further analyse the outcome if a guarantee was issued by the parent company as security for the loan to STAI.

The Court summarized the key propositions emerging from Chevron and Glencore cases as regards subdivision 815-A of the ITAA 97 as follows;

(1) Subdivision 815-A and the Associated Enterprise article in tax treaties between Australia and other countries permit "a broad and a wide-ranging inquiry into the relations existing between the enterprises concerned." The factual inquiry into the conditions operating between the enterprises is "unconfined by the terms of the associated enterprise Article or by the terms of S 815-15(1)(b)";
(2) the causal test referred to in subsection 815-15(1)(c) is a flexible comparative analysis that gives weight, but not irredeemable inflexibility, to the form of the transaction actually entered into between the associated enterprises;
(3) the form of the transaction may to a degree be altered if it is necessary to do so to permit the transaction to be analysed through the lens of mutually independent parties;
(4) the comparison required by subsection 815-15(1)(c) and the associated enterprises article will generally require that the parties in the hypothetical case will generally have the characteristics and attributes of the actual enterprises in question; and
(5) the answer to the question whether non-price terms of a transaction may be the subject of substitution was left open in *Glencore*.[7]

Having stated the key propositions from *Chevron* and *Glencore*, the Court proceeded to apply subdivision 815-A in the following words:

> In my view, having regard to the facts and circumstances as described earlier in these reasons, a reliable hypothesis is that independent parties in the position of SAI and STAI (and SingTel) might have been expected to have agreed in June 2002 that the interest rate applicable to the loan notes would be the 1 year BBSW plus 1% with resulting amount grossed up by 10/9 (that is, the same rate as was actually agreed in the original LNIA), interest under the loan notes could be deferred and capitalized, and, there would be a parent guarantee from a company like SingTel of the obligations of the company in the position of STAI. Further, having agreed to the transaction with these components in June 2002, a reliable hypothesis is that independent parties in the positions of SAI and STAI would not have agreed to make the changes contained in the Second Amendment. In particular, they would not have agreed to introduce the benchmark terms and add the Premium of 4.552%. Further, having agreed to a transaction with the components described above in June 2002, a reliable hypothesis is that independent parties in the positions of SAI and STAI would not have agreed to make the changes in the Third Amendment. That is, they would not have agreed to change the component of the interest rate that was the 1 year BBSW to a fixed amount of 6.835%. It follows that, in my view, in the hypothesis, the interest rate of the 1 year BBSW plus 1% with the resulting amount grossed up by 10/9, would have (or might be expected to have) continued through the whole life of LNIA."[8]

The Court went on to give its reasons for its decisions above.

> … [T]here was no parent guarantee in the agreement between the parties, and it was unnecessary because the parties to the transaction, SAI and STAI were both wholly owned by the same company. However, in the context of the nature of the transaction, the logic of the situation points to a parent guarantee.[9]

The court drew attention to the fact that there was a wide disparity between the credit rating of SingTel and STAI, AA-/A1 against BBB- to BB respectively. This would in the normal course of event [have] resulted in [a] higher rate of interest charged on the loan notes, which would have been reduced or removed by the provision of a parent guarantee from SingTel.

The court further said:

> In these circumstances SingTel is likely to prefer to provide a guarantee rather than allow its wholly owned subsidiary, STAI to pay a much higher amount of interest (which would likely affect the parent's financial position). Given the size of the transaction (vendor finance of $ 5.2 b) even a small increase in the interest rate would result in a large dollar amount of additional interest being payable.[10]

4. Constructing the Hypothetical

Subdivision 815-B was introduced by Act No.101 of 2013, which inserted subdivisions 815-B, 815-C and 815-D into the ITAA 1997 while repealing division 13 of the ITAA 1936, with effect from 29 June 2013. These amendments ensure that Australia's transfer pricing rules better align with the arm's length principles and internationally consistent transfer pricing approaches as set out by the OECD.

The above amendments have firmly established that the Commissioner has a separate power to tax by virtue of article 9 of the OECD Model, irrespective of what is contained in subdivision 815-B. In TR 2014/6 the Commissioner states as follows:

> Article 9 is concerned with the conditions and profits resulting from the commercial or financial relations between associated enterprises, not merely with the particular labels assigned to those relations. The form chosen to document a transaction or arrangement does not necessarily dictate its substance, or whether it is commercially rational, or inform as to whether it has been undertaken at arm's length. In applying the arm's

7. *Singapore Telecom* (2021), para. 156.
8. Id., para. 322.
9. Id., para. 324.
10. Id.

> length principle, it is important to consider the economic reality and effect of a transaction or arrangement (that is, its substance), rather than proceeding only on the basis of how it has been characterized or structured.

On instances in which the Commissioner may undertake a reconstruction, the Ruling states:

> The application of subsection 815-130(3) also requires that the other commercial or financial relations must differ in substance from the actual commercial or financial relation. However, this doesn't mean that they must be entirely different. The other commercial or financial reasons acceptable to independent entities dealing wholly independently with one another could both retain and reject elements of the actual relations and would include any additional elements on which independent entities would insist.

The above passage from the Ruling seems to suggest that the Commissioner may exercise the power to reconstruct in cases where the arm's length conditions merely differ but do not go far as to be entirely different, giving the Commissioner a wide range of instances in which he may reconstruct.

5. Parental Guarantee

Although the Court discussed at length the part that would be played by a parent guarantee in the case of an intercompany loan, no lessons for the future course of litigation or tax administration could be drawn from the judgment. In *Chevron*, a parent guarantee was imputed under arm's length conditions, since it was the policy of the Chevron group to provide a guarantee in order to secure low cost of funds in its operations. No such definite view could be gleaned from the decision in the *Singapore Telecom* case, except that the logic of the situation dictated that a parental guarantee be provided if the parties were dealing with each other at arm's length. The Court stated that "a reliable hypothesis is" that independent parties in the position of SAI and STAI would have agreed that there be a parent guarantee. Since it was decided in *Singapore Telecom* that under the arm's length conditions the loan note should be regarded as an interest rate agreed by the parties at the outset (which was the basis of the assessment) and which was lesser than under the amendments, the question of a parent guarantee did not feature prominently in the judgment. If, on the other hand, a parent guarantee was considered to be an integral part of the loan in arm's length conditions, then the Court would have even gone further and reduced the interest rate to be set lower than the original rate agreed by the parties.

5.1. Guarantee fee

Following judgments in *Chevron* and *Singapore Telecom*, courts hereafter dealing with intercompany loans, will be confronted with making decisions on parent guarantees when determining arm's length pricing between parties. In both mentioned cases, the Federal and Full Federal Court held the view that a parent company guarantee would have a significant impact on the interest rate agreed to by the parties. Courts in the future will also have to deal with the issue of any guarantee fees payable by the subsidiary and its effect on arm's length pricing of the intercompany loan.

6. Conclusion

It is increasingly clear that transfer pricing disputes involving cross-border funding will continue to cause uncertainty for both taxpayers and tax authorities. Since the parent guarantee is becoming prevalent in funding issues, the effect of a fee payable for the guarantee will also have to be given due consideration when determining the quantum of the transfer pricing benefit accruing to the taxpayer. These matters need clarification by the Commissioner or by the High Court in order to avoid conflicting views in the future.

