Chapter 2

Australia

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This chapter is based on information available up to 2 March 2012.

2.1. Corporate income tax framework

2.1.1. Corporate income tax system

An Australian resident company is subject to Australian income tax on its non-exempt worldwide income. A non-resident company is subject to Australian tax only on Australian-sourced income.¹

Companies incorporated in Australia are residents of Australia for income tax purposes, as are companies carrying on business in Australia with either their central management and control in Australia or their voting power controlled by Australian residents.²

For transfer pricing, Division 13 of Part III of the Income Tax Assessment Act 1936 (ITAA 1936) provides a mechanism by which Australia adopts the arm’s length principle for taxation purposes as the basis for ensuring that Australia receives its fair share of tax.

2.1.2. Taxable entities

Australian resident companies and individuals are generally subject to Australian income taxation on their non-exempt worldwide income. There are

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2. See the definition of “resident or resident of Australia” in section 6(1)(b) of the Income Tax Assessment Act 1936 (ITAA 1936).
also specific rules about the treatment of certain entities, such as trusts, partnerships, etc.\textsuperscript{3}

\subsection*{2.1.3. Taxable income}

Taxable income is calculated as assessable income less allowable deductions. Assessable income consists of income as defined by ordinary concepts and income that is specifically assessable under a statutory provision.\textsuperscript{4} Allowable deductions consist of general deductions (broadly losses or outgoings incurred in gaining or producing assessable income) and deductions that are specifically allowed under a statutory provision.\textsuperscript{5}

\subsection*{2.1.4. Tax losses}

Tax losses may be carried forward indefinitely against assessable income derived during succeeding years, subject to certain limitations. To claim a deduction for past losses, companies must satisfy either a continuity of ownership test or a same business test. Losses may not be carried back.\textsuperscript{6}

\subsection*{2.1.5. Tax rates}

For the 2011 to 2012 tax year, resident companies are subject to Australian income tax at a rate of 30\% (the government has committed that the rate will be reduced to 29\%, effective from the 2013 to 2014 tax year).\textsuperscript{7} Income of non-resident companies from Australian sources is similarly taxable at 30\% if it is not subject to withholding tax or treaty protection.

\begin{itemize}
\item \textsuperscript{3} See Divs. 5 and 6 ITAA 1936.
\item \textsuperscript{4} See Div. 6 ITAA 1997.
\item \textsuperscript{5} See Div. 8 ITAA 1997.
\item \textsuperscript{6} Division 36 of the ITAA 1997 provides an outline of the general rules regarding the calculation and utilization of tax losses of earlier income years.
\item \textsuperscript{7} Press Release No. 13 of 2012 from the Deputy Prime Minister and Treasurer Mr Wayne Swan. Note that for “small business” companies the 29\% rate will apply from the 2012-13 income year.
\end{itemize}
2.1.6. Interaction of thin capitalisation and transfer pricing legislation

On 27 October 2010, the Australian Taxation Office (ATO) released its final ruling (Taxation Ruling TR 2010/7) on the interaction of the thin capitalisation and transfer pricing provisions. The final ruling includes the ATO’s observations on the application of appropriate transfer pricing methods to determine the arm’s length consideration for cross-border intra-group debt arrangements having regard to the interaction with the thin capitalisation rules.

Broadly, TR 2010/7 indicates that the transfer pricing rules apply first to determine the arm’s length interest rate applicable to a debt arrangement entered into between international related parties. The thin capitalisation rules are then applied to determine whether some portion of that interest is not deductible. When determining an arm’s length interest rate, the taxpayer must assess whether the existing level of debt provides an arm’s length capital structure even though the level of debt complies with the thin capitalisation rules. If it does not, a hypothetical arm’s length level of debt, which results in an arm’s length capital structure, will need to be used when determining the arm’s length interest rate. The arm’s length interest rate derived based on the hypothetical level of debt is then applied to the actual level of debt allowed under the thin capitalisation provisions.

Section 2.3.3. of this chapter provides a more detailed commentary on TR 2010/7 and the interaction between the transfer pricing and thin capitalisation provisions.

2.2. Overview of intra-group financing in Australia

2.2.1. Historical context

The ATO released Taxation Ruling TR 92/11 in 1992 to deal with specific issues in relation to interest payments, loans and equity contributions. In particular, the ruling discusses the general approach accepted by the ATO in pricing intra-group loans. This ruling also provides factors which should be

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considered in determining whether an arrangement should be characterized as debt or equity. These factors are discussed at 2.3.1.1. below.

Prior to 2007, the transfer pricing legislation and the thin capitalisation provisions were largely seen as operating independently of each other. That is, when the level of debt was within the safe harbour threshold set out in the thin capitalisation provisions, it was generally accepted that the funding arrangement represented an arm’s length capital structure. Therefore, the “safe harbour” capital structure could be used for the purposes of determining the arm’s length interest rate to be applied rather than the hypothetical capital structure referred to above. The only clear distinction in the application of transfer pricing principles was in the determination of an “arm’s length” amount of debt (an alternative to using the “safe harbour” debt amount for thin capitalisation purposes).

Although this analysis follows the broad transfer pricing principles in relation to what constitutes an “arm’s length” amount of debt, it forms part of the thin capitalisation legislation and therefore includes a number of assumptions and adjustments in relation to the debt and assets of the taxpayer. Given what is generally regarded as a relatively generous 3 to 1 debt to equity ratio for non-authorized depositary institution (non-ADI) taxpayers (i.e. generally taxpayers other than banks), the arm’s length debt amount under the safe harbour provisions is used infrequently. The arm’s length debt test for thin capitalisation purposes is therefore not discussed further in this chapter.

2.2.2. Recent developments

Commencing in 2007, the ATO began to officially indicate that intercompany financing (and in particular the interaction between the transfer pricing and thin capitalisation provisions) was becoming an increasing area of focus. The ATO was concerned that taxpayers could have capital structures that were within the thin capitalisation safe harbour, but resulted in such an adverse impact on financial performance that the arm’s length basis on which the related parties were dealing should be called into question. To clarify their position and obtain feedback from the broader taxpayer community and their advisers, the ATO released a draft Taxation Determination (TD 2007/D20) in November 2007 outlining its view on the interaction between the transfer pricing and thin capitalisation provisions, as well as a draft discussion paper (ATO Discussion Paper: Intra-group finance guarantees and loans: Application of Australia’s transfer pricing and thin capitalisation rules) in June 2008. These documents were subsequently withdrawn in December 2009,
when the ATO released the initial draft of a new Taxation Ruling (TR 2009/D6), as well as a draft Practice Statement (PS LA 3187).

Ultimately, these documents were replaced when the ATO issued Taxation Ruling TR 2010/7 in October 2010, the finalized version of TR 2009/D6 (see 2.3.3.2. below). Although this is the only document which is binding on the ATO, the earlier discussion documents are helpful in providing some indication of the ATO position regarding intra-group financing arrangements. This is particularly relevant given the guidance included in TR 2010/7 is less comprehensive than that which was previously provided, particularly in relation to guarantee arrangements. Further, the binding part of TR 2010/7 does not provide any detail regarding how the transfer pricing principles should be applied to debt arrangements; this exposition is instead included in an Appendix to the ruling, which the ATO indicates is non-binding.

In summary, the guidance provided in this final ruling indicates the ATO’s preference to adopt a “holistic” approach to funding arrangements, with a focus on the following three key factors:

– *parent affiliation*: Whether the taxpayer’s relationship with its parent company provides support that should be considered in determining an arm’s length interest rate;

– *financial independence*: Whether the taxpayer’s capital structure is consistent with that of a “financially independent” company (i.e. is it an “arm’s length capital structure” when benchmarked against other comparable companies); and

– *commercial realism*: Whether the taxpayer’s profit before tax (i.e. profit after interest expense) makes sense in the context of other comparable companies.

This holistic approach incorporating these elements is focused not only on the pricing of the actual debt, but also on the economic context of the intra-group funding arrangement. It is this broader context which makes the ATO’s approach contentious when compared to what was previously seen and generally accepted in practice. As outlined in 2.1.6. above, TR 2010/7 requires a taxpayer to have reference to an “arm’s length” capital structure in determining an appropriate interest rate and provides that the taxpayer should subsequently apply the interest rate so determined to the actual amount of debt allowed under the thin capitalisation provisions. This raises an issue in relation to whether Australia’s transfer pricing rules, contained in Division

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10. PS LA 3187, A practical “rule of thumb” approach for the transfer pricing of interest payable by a taxpayer on a cross-border related party loan, an interim measure to alleviate uncertainty prior to the release of TR 2010/7.
13 of the ITAA 1936 (Division 13), allow the Commissioner to substitute this hypothetical “arm’s length” capital structure for the actual amount of debt when determining the interest rate.

The ATO contends that this approach is not new and that the approach outlined in TR 2010/7 is based on the guidance provided in TR 92/11 and is representative of the historical ATO position. The ATO claims that any comments presented in TR 2010/7 are simply a “clarification” of the guidance previously provided by TR 92/11 and thus the ruling applies retrospectively. The retrospective application of this ruling is also contentious given what was considered to be the generally accepted approach and the judgments set down in recent transfer pricing cases discussed below. These cases concluded that the Australian transfer pricing provisions should be applied on a transaction basis, i.e. the arm’s length or market price of the related party transactions should be reviewed, not whether there is arm’s length behaviour or appropriate profits arising from such related party transactions. As outlined below, the Australian Treasury is currently working on a rewrite of the transfer pricing legislation that is expected to clarify the situation at least on a prospective basis but may also apply retrospectively when treaty countries are involved.

It is further noted that the wording of the tax treaties regarding the treatment of international related-party dealings (as contained in the Business Profits and Associated Enterprises articles) is different to Australia’s existing transfer pricing provisions. In particular, the tax treaties provide that the profits should be allocated in an arm’s length way. This wording may more readily accommodate the hypothesizing of an “arm’s length” capital structure for the taxpayer and support the ATO’s preference for financing arrangements to result in a “commercially realistic” outcome.

The government intends to “clarify” that the transfer pricing rules in the treaties allow the Commissioner to make adjustments independently of the domestic transfer pricing legislation. Exposure Draft legislation which was released on 16 March 2012 outlines that the new legislation will apply for income years commencing on or after 1 July 2004.

The application of the “profits” approach outlined in the tax treaties on a retrospective basis is highly contentious and may represent a significant risk to taxpayers who have existing intercompany loan arrangements with affiliates in treaty countries. This approach is most likely to affect companies with high levels of debt and low levels of profitability, where the application of the transfer pricing provisions using a transactional/market rate approach
may result in a different outcome to an approach that considers the overall profitability of the entity after all international related-party transactions, including debt.

2.2.3. Proposed legislation rewrite

The ATO has recently concluded two transfer pricing cases: *Roche Products Pty Limited v. Commissioner of Taxation* [2008] AATA 261 in April 2008 and *SNF (Australia) Pty Ltd v. Commissioner of Taxation* [2010] FCA 635 in June 2010. In both cases, the decision, and the reasons for the decision, brought into question the approach taken by the ATO in determining an arm’s length consideration and in particular whether the use of the transactional net margin method (TNMM) favoured by the ATO is appropriate under the existing transfer pricing legislation. A summary of these cases and the decisions is included in the Australian chapter of the IBFD Transfer Pricing Collection.

In part as a reaction to these decisions and the controversy surrounding the issuance of TR 2010/7 on a retrospective basis, the Assistant Treasurer announced on 1 November 2011 that Treasury would be undertaking a reform of Australia’s transfer pricing provisions.11

On 16 March 2012, Treasury released the first exposure draft which addresses retrospective aspects of the rewrite of the transfer pricing provisions. These amendments and clarifications are to apply from 1 July 2004 and will only apply to foreign affiliates in treaty countries (i.e. those countries with which Australia has a double tax agreement). Further exposure drafts are expected to be released shortly that address the prospective aspects of the legislation as well as the attribution of profits to permanent establishments, which will apply to all taxpayers.

Based on the initial exposure draft, not only has TR 2010/7 been written into the transfer pricing legislation but it is also clear that the Commissioner intends to maintain and “clarify” his position that the treaties may be used as a separate taxing power. The separate taxing power is perhaps the most contentious aspect of the transfer pricing legislative rewrite as it provides the Commissioner the potential to recharacterize transactions to reflect what would be expected to occur between independent parties based on overall profitability.

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For taxpayers with existing intra-group borrowing arrangements with affiliates in treaty countries it will be necessary to consider whether these arrangements have resulted in an appropriate profit being retained in the Australian entity for all financial years commencing after 1 July 2004, as under the proposed new legislation the ATO will have access to a legislated “profits” standard (through the Associated Enterprises and Business Profits articles of the relevant double tax agreements) in assessing the arm’s length nature of these international related-party transactions.

At present, there is some uncertainty regarding the content of the finalized legislation; however, the approach to loans and guarantee fees is likely to be similar to that already described in TR 92/11 and TR 2010/7. Specifically, it is envisaged that the new legislation will contain additional clarity regarding the Commissioner’s ability to recharacterize a loan arrangement and/or hypothesize an “arm’s length” capital structure for the purposes of determining the arm’s length consideration.

2.3. Intercompany loans

This section discusses the current Australian approach to pricing intercompany loans and is divided into three key sections:

– *Loan or equity*: Discusses the relevant debt/equity rules and economic considerations that need to be taken into account in determining whether an instrument will be considered debt or equity for Australian transfer pricing purposes.

– *Interest charged*: Discusses the relevant considerations in relation to intra-group financing from an Australian transfer pricing perspective and is divided into two subsections:
  – *Arm’s length pricing considerations arising from TR 92/11*: Outlines the key factors to be taken into account based on the guidance provided in TR 92/11; and
  – *Considerations arising from TR 2010/7*: Outlines the key factors to be taken into account based on the guidance provided in TR 2010/7.

– *Transfer pricing approach*: Provides a broad outline of the application of the comparable uncontrolled price (CUP) method to financing transactions, in the light of the guidance provided by the ATO.
In addition to the above, reference is made to the pricing of profit participating loans (PPLs) and other hybrid instruments that include both debt and equity components.

2.3.1. Loan or equity

Australia has debt/equity rules contained in Division 974 of the ITAA 1997 that apply for debt and equity interests issued from 1 July 2001 and, in limited circumstances, to certain interests issued before that date. The general object of this division is to establish a test for distinguishing between debt and equity interests with a focus on economic substance rather than on legal form. The test is complex and extends well beyond an examination of whether a borrower has a non-contingent obligation to repay an amount of principal.

Broadly, the scope of the debt/equity rules may impact the following:

– the taxation of dividends (including the imputation requirements);
– the operation of Australia’s thin capitalisation rules; and
– the application of non-resident withholding taxes and related measures.

To address the interplay between Division 974 and Australia’s transfer pricing regime, the ATO has issued Taxation Determination TD 2008/20. The determination outlines that when it is relevant to distinguish between debt and equity in the application of Division 13, the characterization of the transaction for Division 13 purposes is not affected by the classification under Division 974. Here, the determination notes that Division 974 provides a test for determining whether an interest is to be treated as a debt interest or an equity interest for particular tax purposes that do not include the application of Division 13.

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13. TD2008/20, Income Tax: where a taxpayer has supplied or acquired property under an international agreement and that gives rise to a debt interest or an equity interest as defined for the purposes of Division 974 of the ITAA1997, does Division 974 bear upon the characterization to be adopted for the purposes of the application of Division 13 to the transaction?
2.3.1.1. Transfer pricing considerations in relation to debt and equity

TR 92/11 discusses the treatment of certain funding as debt or equity, which relates solely to the treatment of funding for the purposes of determining the arm’s length consideration to be paid and received between the parties (i.e. the characterization for transfer pricing purposes does not affect the broader characterization under the debt/equity rules).

Specifically, it is noted that an interest-free outstanding balance may be considered arm’s length. Predominantly, these situations exist when the balance is to be treated as equivalent to a contribution to equity. The Commissioner quoted the statement in the 1979 Report of the OECD Committee on Fiscal Affairs, entitled Transfer Pricing and Multinational Enterprises, which provides that:

Since for tax and other reasons equity contributions may be disguised as loans, a distinction has to be made between the two. Where it is determined that a financial transaction is a contribution to the equity of an enterprise, it follows that no interest is due.

The factors that will be considered by the ATO in determining whether a particular loan agreement should be treated as equivalent to a contribution of equity include:

- The legal relationship that is established between the provider of funds and the recipient. If the legal relationship is that of a creditor and a debtor, it could generally be expected that Division 13 would be applied to impute arm’s length interest. If the rights and obligation of the provider of funds are similar to that of a shareholder (e.g. voting rights, returns dependent upon profits, etc.), the funds could be treated as equity.

- If the agreement provides for the payment or accumulation of interest, the agreement would generally be treated as a loan.

- If the loan is repayable upon demand or within a short period of time, the funds will generally be treated as a loan unless other facts indicate otherwise.

- If the claim for repayment is not effectively subordinated to the claims of other creditors, the contribution may be considered as equity.
– Use of the funds to invest in fixed assets of a long-term nature for use as core assets of the business may be an indication that the contribution is by way of equity.

– If the debt/equity ratio is very high compared to the average for the particular industry or in the country of investment, this is one of the factors that might indicate that a part of the debt may be equivalent to equity.

– If the funds are contributed by way of a “loan” because of factors affecting the term of investment in the country of investment (e.g. the need for flexibility due to barriers on repatriation of equity, minimum shareholdings by domestic investors), the funds may be considered as equity.

– Where, at a particular time, the activity of a business is such that no arm’s length lender would lend to that business at that time, even on deferred interest terms, this may indicate that the amount in question could be equity (e.g. prospecting or exploration). In cases where an affiliated entity other than the parent is the lender, the question will depend on whether the non-arm’s length lender was as fully informed as the parent company and on the security and consideration offered for the loan.

– The absence of a written loan agreement is not an indication that the contribution is by way of equity.

These are not the only factors that will be taken into account. TR 92/11 outlines that while these and other factors will be relevant, what is important is the total picture that emerges from the transaction. The taxpayer would have to establish that the transaction that bears the legal character of a loan is equivalent to a contribution to equity.

Additionally, during a start-up or market penetration period, it may not be possible to obtain financing from an unrelated party due to the lack of security or lack of income flow. Here, the granting of an interest-free loan may be acceptable and there may be commercial or regulatory reasons as to why any contribution is structured as a loan versus share capital. An example is in the mining and resources industry in the exploration phase where upfront cash is required, but where third-party loans would generally not be available due to no income being derived. The funds may be contributed as an interest-free loan rather than capital as the local regulatory environment may restrict the ability of the parent entity to recover an equity investment, but where repayment of debt (including interest free debt) is not subject to similar restrictions.
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There is no definition of start-up period; nor is there a provision regarding the length of a start-up period. There is also no requirement that the lender also supply goods or services to the borrower. The onus would be on the taxpayer to prove that the amount was akin to equity. Also, it may be considered whether the arrangement should contain some form of deferred interest payment.

During financial difficulties, it may not be possible to obtain loans from independent lenders and pay interest due to the lack of an income flow. Here, depending on the facts and circumstances, the granting of an interest-free loan may be accepted. However, the ability of the borrower to obtain financing from an unrelated party is only one of the factors to be taken into account. The possibility of an interest deferral arrangement would also need to be considered.

2.3.2. Profit participating loans (PPLs) and hybrid debt instruments

PPLs and hybrid debt instruments differ from “vanilla” loan arrangements in that they include some component of (usually variable) equity return to the lender. As discussed above, it is necessary to consider whether such instruments are characterized as debt or equity from both a transfer pricing and tax perspective.

As outlined in TD 2008/20, the classification of the arrangement as debt or equity under Division 974 does not affect the characterization of the arrangement for transfer pricing purposes.

Where an arrangement is characterized as debt for transfer pricing purposes, all of the considerations outlined in 2.3.3. below would apply to the pricing of such instruments. However, as outlined in TR 92/11, if the arrangement, or some part of the arrangement, is classified as equity or “quasi-equity”, then the “interest” associated with the arrangement or part of the arrangement should not be charged. As discussed below, TR 2010/7 sets out the possibility that some part of the arrangement may be treated as “hypothetical equity” for purposes of pricing the overall arrangement (i.e. interest is not specifically disallowed but the quantum of interest that may be charged on the overall arrangement is reduced).
2.3.3. Interest charged

2.3.3.1. Arm’s length pricing considerations arising from TR 92/11

Further to the above considerations regarding the characterization of an outstanding intercompany balance as debt or equity for transfer pricing purposes, TR 92/11 provides an overview of the key considerations to be taken into account in determining arm’s length pricing in relation to an outstanding intercompany balance. To determine an arm’s length interest rate, all the relevant facts and circumstances surrounding the loan will be considered. As outlined in TR 92/11, these include:
– nature and purpose of the loan;
– market conditions at the time the loan was granted;
– amount, duration and terms of the loan;
– currency in which the loan is provided and the currency in which repayment has to be made;
– security offered by the borrower;
– guarantees involved in the loan;
– credit standing of the borrower;
– situs of lender and borrower; and
– prevailing interest rates for comparable loans.

The preferred method for determining the arm’s length consideration in relation to loan agreements is the CUP method.

For Australian dollar-denominated loans, the appropriate reference rate will depend on the facts and circumstances of the particular case, however, common reference rates include the Australian dollar (AUD) London Interbank Offered Rate (LIBOR), the Bank Bill Swap rate (BBSW) and the AUD swap rate.

For euro currency and Asian currency loans, the LIBOR and the Singapore Interbank Offered Rate (SIBOR) may, respectively, be taken as indicative of the risk-free interest rate. Appropriate margins will be added to this base rate to reflect the specific terms and conditions of the loan and the credit risk of the borrower.

To determine the appropriate margin to include on the base interest rate for related-party loans, the credit rating of the borrowing entity is generally reviewed absent comparable unrelated-party loans. Where an independent rating agency has determined a credit rating of the entity this may be used. However, where an independent rating agency has assigned the credit rating,
it is important to consider whether this has been determined on the basis of the entity being a stand-alone entity or if it has considered that it is part of a global group. In general, this type of credit rating information is not readily available and it is therefore necessary to make an independent assessment of an indicative credit rating (or score) for the borrowing entity. Ratings agencies such as Standard & Poor’s and Moody’s have models available which determine an indicative credit rating based solely upon various quantitative factors (e.g. financial performance indicators based on various information included in the entity’s income statement and balance sheet). This rating may need to be adjusted in light of various qualitative factors (e.g. market position, stability of earnings, etc.).

Once a credit score has been assessed, this can then be used to benchmark appropriate interest rates or margins. Data is available from information providers such as Reuters and Bloomberg of average bond rates for each credit score, e.g. A+, A-, etc. Given the small size of the Australian market, for lower credit scores, information may not be available for the relevant time period. In this instance, information may be sourced from another market (most commonly the United States) and foreign exchange swap rates used to provide an Australian equivalent interest rate.

2.3.3.2. Considerations arising from TR 2010/7

TR 2010/7 indicates that when pricing cross-border intra-group debt, taxpayers should follow existing ATO guidance, most relevantly TR 92/11 and Taxation Ruling TR 97/20 (which deals with arm’s length transfer pricing methodologies). The ruling does not mandate any particular approach; rather, it stresses the overriding criteria that the taxpayer’s associated enterprise debt arrangements must reflect a commercially realistic outcome.

A taxpayer must assess whether the pricing of its intra-group debt makes commercial sense in the taxpayer’s circumstances. When it is considered that the intra-group debt pricing results in financial costs that do not leave a commercially realistic return for the taxpayer’s relevant business activities, the Commissioner contends he has the power to look beyond the usual transfer pricing methods and substitute an arm’s length capital structure when determining the arm’s length interest rate. This is an issue that is subject to contention and will hopefully be clarified, at least on a prospective basis, with the issuance of revised transfer pricing legislation.
It is not acceptable to the Commissioner for taxpayers simply to determine a market price for the actual level of intra-group debt. Rather, an assessment is required as to whether the level of funding costs result in an overall financial outcome that is commercially realistic for the individual taxpayer.

The ruling outlines two relevant considerations which may be appropriate to ensure that the outcomes are commercially realistic, while noting they are not necessarily the only considerations:

– The first is the “financially independent” or “arm’s length capital structure” consideration. This consideration requires an assessment of the level of debt the taxpayer would have borrowed if it were acting as a financially independent entity.

– The second, generally known as “parental affiliation” consideration, looks at whether the credit rating of the parent is relevant for setting the interest rate payable by a subsidiary entity on the debt.

While the ruling stresses that it does not require a taxpayer to work out an arm’s length amount of debt to demonstrate that the pricing of its debt is consistent with the transfer pricing provisions, it does state that taxpayers must always assess whether the associated enterprise debt arrangements reflect a commercially realistic outcome. It would appear that the only way this can be done is for a taxpayer to assess what an arm’s length capital structure would be for the entity if it were acting financially independently.

In general, the ATO would expect to see some indication of the process undertaken in determining whether the actual capital structure is arm’s length. One method would be to benchmark the actual capital structure of the taxpayer against that of comparable entities operating in the same industry, for example by comparing the debt to equity ratios of the relevant entities. Based on recent experience, the ATO approach is also likely to involve a determination of whether the borrower’s profit before tax is also commercially realistic when benchmarked against other comparable companies. This profits based approach can raise significant issues with the relevant treaty partner where a transactional or market-based approach would support the interest deduction. This approach is more likely to be pursued by the ATO given the recent exposure draft, which specifically provides for such a profits-based approach.

Further, the ruling notes that when the operations of the borrower are core to the group, “in the sense that its functions are a vital part of an integrated
business”, it would generally be expected that the borrower company would have the same credit rating as its parent. Accordingly, most taxpayers will now be required to assess whether their cross-border intra-group debt fits within an arm’s length capital structure and whether its operations are so core to the global group that the parent company credit rating is the appropriate rating to apply to the borrowing. These considerations exist even if the debt levels fall within the thin capitalisation safe harbour amounts.

Notwithstanding the above, TR 2010/7 indicates that it is not intended to override the thin capitalisation rules. Rather, the ruling suggests that any debt deductions which need to be considered for thin capitalisation purposes must previously have been concluded as being deductible under all other parts of the tax legislation. The ruling suggests that this indicates that any amounts considered as debt deductions under the thin capitalisation rules must have already been determined as deductible under the transfer pricing rules; i.e., the amounts for which a taxpayer seeks to claim a deduction must have been determined at arm’s length. Therefore, although it is necessary to apply the transfer pricing rules in advance of the thin capitalisation rules to determine an arm’s length outcome (e.g. interest rate), the amount of debt to which such an outcome applies is determined under the thin capitalisation rules. This is detailed in the example at 2.3.5. below.

2.3.4. Transfer pricing approach

Further to the above considerations, the following section includes a detailed step plan indicating how the CUP method may be applied in practice.

2.3.4.1. Steps in the application of the above approach

The CUP method is generally preferred in assessing intra-group financing arrangements. The CUP is applied based on either internal or external comparable data.

To consider all the principles outlined in TR 2010/7, taxpayers will need to address the following steps when pricing cross-border intra-group debt.

**Step 1:** Determination of legal entity – For the purpose of the analysis, it is important to determine the legal entity that has undertaken the borrowing. Consideration also needs to be given as to whether there are financial guarantees provided by other group members in the group in respect of the
borrowing. If so, it may be appropriate to analyse the consolidated Australian group’s financial position, or some other entity combination, rather than just the borrowing entity.

**Step 2:** Comparable uncontrolled transactions – Has the group entered into any comparable independent party transactions? In this analysis it is important to consider carefully the terms and conditions of the debt and the relevant borrowing entity. We often find that external-party debt is senior to any related-party debt. The different levels of subordination means the external interest rate is not an appropriate arm’s length rate for the internal debt unless appropriate adjustments can be made. Also, if a different entity has undertaken the external versus internal borrowing then a direct comparison of interest rate is not appropriate either. A letter from a bank offering a particular interest rate is not considered robust evidence of an independent-party transaction by the ATO. This is because these letters rarely represent a binding contract and the terms and conditions of the actual related-party borrowing have usually not been adequately considered in the bank’s offer letter.

**Step 3:** Establish stand-alone credit rating of borrower – Where an independent rating agency has determined a credit rating of the borrowing entity this may be used. However, this will only be useful if the independent rating agency has assigned the credit rating on the basis of the entity being a stand-alone entity having regard to adjustments that may be required to comply with TR 2010/7. In general, this type of credit rating information is not readily available and it is therefore necessary to make an independent assessment of an indicative credit rating (or score) for the borrowing entity. Ratings agencies such as Standard & Poor’s and Moody’s have models (available for external license) which determine an indicative credit rating based solely upon various quantitative factors. This rating may need to be adjusted in light of various qualitative factors, e.g. market position, stability of earnings, etc.

The determined credit rating can then be applied to the terms and conditions of the loan and an appropriate interest rate determined. Prior to the finalization of the ATO’s views in TR 2010/7, it was considered that this interest rate would then represent an arm’s length rate. However, the final ruling (and the draft ruling before it) have now outlined that the ATO considers the following additional steps are also necessary.

**Step 4:** Financial independence criteria – An analysis is now required as to whether the capital structure adopted by the taxpayer may be considered arm’s length in light of its specific facts and circumstances (e.g. maturity,
industry, etc.). To make this assessment, taxpayers will need to benchmark how independent parties in their industry structure their financial arrangements, and make an assessment of what constitutes an arm’s length capital structure. If it is determined that the actual level of debt is above an arm’s length amount, then an arm’s length capital structure needs to be substituted when performing the analysis in Step 3. This will then result in a higher credit rating and thus lower interest rate being determined in respect of the borrowing.

**Step 5**: Parental affiliation criteria – An analysis of the relative importance of the borrowing entity to the global group is now required. If it is considered that the operations of the borrower are core to the group, in the sense that its functions are a vital part of an integrated business, the ATO considers that the global group would not let the borrowing entity default on its debt obligations. Therefore, the ATO considers in this circumstance that the borrowing entity effectively shares the same credit rating as its parent or global group. There is also the potential for partial notching of the stand-alone credit rating determined up to Step 4, if the borrowing entity is considered strategically important to the group, but not core. Again, this step has the impact of improving the borrowing entity’s credit rating and thus decreasing the determined interest rate.

Additional consideration is necessary when the parent entity has assumed some portion of the default risk of the subsidiary, e.g. through the provision of a performance guarantee. This is relevant for limited risk distribution arrangements when the parent entity provides a guaranteed return to an operating subsidiary. Here, there is likely to be a stronger argument for notching the subsidiary credit rating up towards the parent rating, as the default risk of the parent entity (in relation to the intercompany performance guarantee) may be a more accurate indication of the credit risk of the subsidiary.

If the parental affiliation criterion is the dominant factor in determining a credit rating for the borrowing entity, then it is possible to skip Step 4 and move straight to the parent or global group’s credit rating, as this will generally be a higher rating than the local borrowing entity.

**Step 6**: Application of credit rating to terms and conditions of borrowing – The resultant credit rating is then applied to the specific terms and conditions of the loan to determine an arm’s length interest rate. As outlined above, this rate is then applied to the actual amount of debt allowable under the thin capitalisation provisions. The terms and conditions to consider include: time to maturity, currency, fixed or floating rate, level of subordination, security
provided and payment in kind (most commonly the ability to capitalize interest).

2.3.4.2. Impact of ordering of the above steps

When no one factor is dominant in determining a credit rating for the borrowing entity, the order of application of the above steps may have a substantial effect on the final determined arm’s length credit rating and interest rate.

For example, first notching the credit rating of the subsidiary based on parental affiliation may result in a credit rating which is subsequently considered representative of an arm’s length capital structure (e.g. if the credit rating is notched from BB to BBB). In such a case, it may be concluded that an arm’s length interest rate may be determined based on a credit rating of BBB.

By contrast, first notching based on financial independence may then require additional notching to address the parental affiliation criterion (e.g. notching from BB to BBB- based on financial independence and subsequently notching up again to A- based on parental affiliation). That is, based on the same facts, applying the steps in a different order may result in a different conclusion as to the arm’s length credit rating (in this case, A- compared to BBB).

Therefore, in the absence of specific guidance from the ATO specifying the order of application of the three key considerations, there is potential for controversy in the way in which a taxpayer applies the principles outlined in TR 2010/7, even when each principle is applied appropriately.

2.3.4.3. Potential adjustments when the financing transactions produce non-commercial outcomes

When the Commissioner concludes that the financing transactions in their totality result in a non-commercial outcome for the business (as represented by the overall profitability of the controlled entity), the Commissioner may seek to apply the additional powers granted under the transfer pricing provisions to adjust the other international related-party transactions (IRPT) of the taxpayer to ensure the pre-tax outcome is “commercially realistic”. Here, we have summarized below four possible scenarios and the likely position of the Commissioner in relation to the Australian taxpayer’s transfer pricing arrangements.