

Tax Brief

23 December 2009

Transfer pricing and thin capitalisation

Amid the flurry of pre-Christmas desk clearing in the ATO was one long running and important matter of great concern to corporate Australia. The ATO has replaced its 2007 draft determination on the relationship of the thin capitalisation and transfer pricing rules with a draft ruling, as well as releasing a draft practice statement and two opinions it has obtained from counsel on the technical issues. Though the matter is not yet settled, the ATO position has firmed up on the middle ground in terms of its previous consideration of the issue.

The conundrum

The thin capitalisation rules provide a 3:1 debt to equity safe harbour ratio for general inbound and outbound investment (with various special rules for financiers). The transfer pricing rules (both in domestic law and treaties) limit the consideration for transactions between related parties to the amount that would be charged between arm's length parties. Although transfer pricing is generally thought of in terms of correct pricing of the actual transactions between the parties, in recent times it has been accepted by the OECD (and 'endorsed' by the ATO) that in certain cases (of which thin capitalisation is one) the rules extend to disregarding/restructuring actual transactions as well as pricing.

The problem is how the two regimes interact. This is best understood in the context of an example in an earlier, June 2008 ATO discussion paper on the issue. Suppose that an Australian subsidiary of a foreign parent has \$400m of assets and is funded by share capital of \$100m and loans of \$300m at 15% interest from its parent. On this basis it has satisfied the safe harbour ratio of the thin capitalisation rules and claims annual deductions of \$45m for interest. Assuming that the maximum amount that the subsidiary could borrow on arm's length terms in the open market was \$190m with an interest rate of 12%, can the ATO deny some of the \$45m interest deductions under transfer pricing rules?

The ATO solution

The ATO view in the old and new draft rulings is that it can deny some of the deductions on the basis that the thin capitalisation rules determine the amount of permissible debt on which deductions can be claimed, but that the transfer pricing

Greenwoods & Freehills

rules determine the interest rate. The ATO also says how much interest is allowed – which is the market rate of interest at which the subsidiary could actually borrow applied to the actual amount of its debt up to the maximum debt level permitted under the safe harbour rules, even if that amount of debt exceeds what the subsidiary could actually borrow in the open market.

In terms of the example above, this means that the subsidiary can deduct \$36m being interest at 12% (the market rate on its maximum possible borrowing of \$190m) on the \$300m of actual debt which is at the safe harbour limit. The ATO accepts that it cannot limit the interest deduction to \$22.8m (\$190m at 12%) as in effect this would mean that the transfer pricing rules would override the thin capitalisation rules and make the safe harbour useless. The ATO rejects the view that it must accept the safe harbour amount as in effect a deemed arm's length amount of debt and then carry out the transfer pricing analysis of the interest rate on that basis.

What is new in the current draft is some more elaboration of how to apply transfer pricing rules to determine interest rates and how the transfer pricing rules in treaties operate.

Determining the arm's length interest rate

With regard to the former, the main problem remains that the ATO avoids addressing the real issue by convenient assumptions. It is obvious that interest rates vary with the riskiness of loans and that it is difficult to say that there is some (fairly low) upper limit on how much a company can borrow. We regularly see examples, even in the current constrained circumstances of the capital markets, of very high arm's length borrowings relative to assets with commensurately high interest rates. The new draft ruling seems to accept that if the subsidiary could have borrowed large amounts at high interest rates, then the interest rate will not be adjusted – in terms of the example above the subsidiary would need to show that it could have borrowed \$300m at arm's length and that if it did so the interest rate would be 15% to succeed in its full interest deduction claim.

The ATO has two strategies, apparently conflicting, to protect itself against this possibility, apart from assuming it away. First, in looking at how much the subsidiary could borrow the transfer pricing exercise is conducted on a stand alone basis for the subsidiary – this supports its argument for lower rather than higher total borrowings on an arm's length basis and avoids the junk bond style interest rates that higher levels of borrowing would support. That is, the fact that the subsidiary is part of a larger group is ignored at this point. (Oddly the ATO continues to say that the arm's length debt test in the thin capitalisation rules is not an application of transfer pricing principles even though it uses the same assumption).

Then once this upper limit on borrowing is determined, regard is had to the creditworthiness of the group as a whole to determine the interest rate on such a

borrowing if that is what the market would do. As the credit rating of a multinational group is likely to be higher than the rating of its individual companies on a stand alone basis again this effectively reduces the interest rate determined under transfer pricing principles. These strategies are more evident in the new draft ruling, though of course the inherent contradiction is not.

The conflict is a legitimate struggle from a policy perspective. If a foreign parent company first goes out of its way to undercapitalise its Australian subsidiary (for example at materially less than a 1:3 equity to debt ratio), and then lends money to that subsidiary at junk bond (arm's length) interest rates, it is not difficult to imagine a spiral in which the disadvantage to the subsidiary of the cap imposed by the thin capitalisation safe harbour limit is more than outweighed by the advantage of the higher interest rate on that part of the debt which is not above the limit.

Treaty transfer pricing adjustment powers

With respect to the long held view of the ATO that the transfer pricing rules in tax treaties provide an independent power to adjust transfer prices, the ATO spells out that its argument is founded on the provisions in the *Income Tax Assessment Act 1936* dealing with amended assessments and penalties in relation to transfer pricing. More detail on this view is found in the main counsel's opinion released along with the draft ruling.

This view runs counter to the preliminary opinion expressed by Downes J in 2008 and so, perhaps as a second line of defence, the ATO seems to change tack. Previously the ATO gave the impression that the treaty powers were broader than the powers in the domestic law and that is the approach in the counsel's opinions. Now the ATO emphasises that the domestic law power is very wide and that it will only be necessary to rely on the treaty argument if it is found that the ATO view on the domestic law is wrong.

The ATO in its general discussion of the transfer pricing and thin capitalisation relationship issue lumps the domestic law and tax treaty transfer pricing rules together and so does not elaborate on exactly how it sees the thin capitalisation rules in domestic law limiting the claimed treaty power – an issue on which counsel's main opinion notes there is 'a potential tension'.

The draft practice statement safe harbour interest rate

Resolution of the issues above in whatever sense does not provide much practical guidance on the interest rate, though the ATO draft ruling does make the important statement that the transfer pricing rules will not be used to nullify the thin capitalisation safe harbour.

The draft practice statement goes one step more towards formalising a rule of thumb announced in mid 2009 for determining the interest rate that can be

Greenwoods & Freehills

applied to the safe harbour amount of debt under the thin capitalisation rules and be accepted by the ATO – a safe harbour for a safe harbour!

The ATO will accept 'the usual interest rate paid by the ultimate parent company' which is elaborated as the weighted average cost of funds on a consolidated basis, adjusted each income year in accordance with movements in the annual average going forward. The rate can include currency and interest rate hedging costs and treasury costs on an appropriate cost recovery basis provided they are not otherwise charged. If that interest rate has been calculated by the parent on an after-tax basis, it can be grossed up by the Australian corporate tax rate (that is, by a factor of 100/70).

The ATO will accept this rate for past income years and for future years including the year of withdrawal of the practice statement when the ATO finally resolves its views on this run longing issue.

The rule of thumb is not available in respect of a cross-border related party loan that has been the subject of an explicit guarantee. The tax treatment of guarantee fees in this context has been part of the debate to date, but is not part of the current package, and so remains unresolved. In a recent decision in the Tax Court of Canada involving General Electric Capital Canada Inc, the line of argument being used by the ATO in this area was not supported and a 1% guarantee fee was found to be equal to or even less than the arm's length amount in the circumstances.

For further information, please contact

Sydney

Tony Frost
tony.frost@gf.com.au
phone +61 2 9225 5982

Melbourne

Richard Shaddick
richard.shaddick@gf.com.au
phone +61 3 9288 1412

These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

Liability limited by a scheme approved under Professional Standards Legislation
510,053,912.doc

Greenwoods & Freehills Pty Limited (ABN 60 003 146 852)

www.gf.com.au

Sydney Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia

Ph +61 2 9225 5955, Fax +61 2 9221 6516

Melbourne 101 Collins Street, Melbourne VIC 3000, Australia

Ph +61 3 9288 1881 Fax +61 3 9288 1828