AUSTRALIA

ATO RELEASES FI NAL RULI NG ON THIN CAPI TALI SATION AND TRA NSFER PRICI NG

The Australian Taxation Office (ATO) recently released Taxation Ruling TR 2010/7, which addresses the interaction between the transfer pricing provisions and the thin capitalisation provisions.

The issue explored by TR 2010/7 is whether the transfer pricing provisions can be applied to reduce (or deny) an entity's deductions for interest and other costs associated with its debt funding, notwithstanding that the entity does not have any excess debt for thin capitalisation purposes.

In this regard, TR 2010/7 states that where an entity does not have excess debt for thin capitalisation purposes, the transfer pricing provisions can still be applied to adjust the allowable deductions in relation to interest and other costs incurred in relation to the debt funding.

TR 2010/7 provides only limited guidance on how to determine the arm's length price in relation to debt funding advanced by an overseas related party, and generally refers readers to its earlier rulings TR 92/11 and TR 97/20. However, TR 2010/7 makes the following general comments.

In practice, the most reliable method is a 'comparable uncontrolled price' approach, which uses available data as to the pricing of a comparable loan between comparable independent parties dealing at arm's length in comparable circumstances.

In the absence of direct comparables, taxpayers may instead use market interest rates applicable to rated borrowers, typically based on a reference rate such as LIBOR or the Bank Bill Swap Rate plus an appropriate margin, to produce a measure of the arm's length consideration.

Alternatively, an arm's length interest rate could be derived from the credit rating of the ultimate parent of the corporate group, with an appropriate margin above the interest rate that the parent would be expected to pay for a comparable loan.
However, the ATO states that in using any data as to uncontrolled comparables or open market prices in determining the arm's length consideration for a related-party loan, it is necessary to take account of whether the outcome makes commercial sense in all of the circumstances of the case.

As an administrative 'concession', the Draft Law Administration Practice Statement (PS LA 3187) provides a rule-of-thumb approach to determining an arm's length amount of interest payable by an Australian subsidiary on a loan from a foreign parent.

Instead of conducting their own 'arm's length' analysis, taxpayers may instead, PS LA 3187states, use an interest rate derived from the weighted average cost of debt of the ultimate parent company, applied to the taxpayer's actual debt amount.

Hypothesising an arm's length price where there is no comparable

TR 2010/7 also provides guidance on an area that has been controversial of late - that is, how the transfer pricing provisions should apply where an entity's debt level is within the thin capitalisation safe harbour, but exceeds the maximum amount of debt that would reasonably be expected to arise between independent parties dealing at arm's length in similar circumstances.

The ATO's approach to this issue is summarised in Example 4 in TR 2010/7.

In that example, the ATO considers the position of an Australian subsidiary that has AUD 400 million of assets, funded by share capital of AUD 100 million and a loan from its foreign parent company of AUD 300 million at an interest rate of 15% (generating annual interest expense of AUD 45 million).

If the loan of AUD 300 million would not reasonably be expected to exist if the Australian company and the foreign parent were independent entities dealing at arm's length with each other, the issue that arises is how to determine the arm's length pricing to apply to the loan. The ATO broadly suggests two possible approaches to this issue:

One approach is to consider the pricing that would apply under the closest alternative arm's length scenario. For example, if an analysis reveals that a loan of AUD 250 million at an interest rate of 10% might be expected to exist between independent parties at arm's length (providing that an additional AUD 50 million of share capital is raised), the ATO suggests that the interest rate of
10% could be applied to the actual loan of AUD 300 million, resulting in allowable interest deductions of AUD 30 million.

Another approach would be to derive an arm's length interest rate from the credit rating of the ultimate parent of the corporate group, and apply that interest rate to the loan of AUD 300 million.

Implications for Australian subsidiaries of multinational groups

The position the ATO takes in TR 2010/7 means that an entity must ensure that the pricing of all international related-party debt is on arm's length terms, even if the entity's total debt is within the thin capitalisation safe-harbour amount.

In situations where no comparable dealings exist (because, for example, the debt funding arrangements in question would not take place between independent parties dealing at arm's length), the ATO suggests the funding should be priced with reference to the pricing that would apply under the closest arm's length scenario, or alternatively based on the rate of interest that the parent company would reasonably expect to pay on a similar loan.

This aspect of the ATO's approach is somewhat controversial. The ATO expects a subsidiary whose balance sheet is more highly geared (because of parent-company loan funding) than would be the case under an 'arm's length' capital structure, to hypothesise a price for the related-party loan based on an assumption that its balance sheet is more conservatively geared than is actually the case.

Alternatively, the subsidiary must hypothesise that its cost of funding is similar to that of its ultimate parent company. Either method will result in a smaller debt deduction than would be the case if one were to hypothesise a price based on the actual gearing or credit standing of the Australian subsidiary.

As a result, the ATO's approach may have the result that the foreign parent becomes exposed to a transfer pricing adjustment in its home jurisdiction if the tax authorities in that jurisdiction consider the interest it receives on the loan to the Australian subsidiary to be less than the arm's length amount.

CUSTO MS-DUTY VALUATIONS

Customs valuation and transfer pricing

Although customs duties have lost their importance in the past few years due to the expansion of free-trade blocs, this is still an area of interest for tax practitioners. Indeed, the pricing of imported goods has been subject to the careful scrutiny of tax authorities for years, but the policy mix of free competition and protection of domestic companies have caused governments to draw up a set of rules on determining the taxable base of customs duties (valuation) and for common understanding of customs tariffs and procedures.

It is worth mentioning that customs duties have been subject to multilateral negotiations that eventually resulted in setting international valuation rules for transactions between related parties. These rules may be seen as particular transfer pricing rules for cross-border sales of goods.

Originally, customs adjustments for imported goods were agreed by the GATT member states in 1979 as part of the Agreement on Implementation of Article VII of the GATT (also known as the Tokyo Valuation Code or the Customs Valuation Code). This agreement has as its core principle that the customs valuation of goods should be based on the price actually paid or payable for the imported goods. Based on this *transaction value*, the intention was to have a fair, uniform and neutral set of rules to determine the taxable base (also known as the *customs value*) of goods by customs authorities worldwide.

The WTO Agreement on Implementation of Article VII of the GATT 1994 (concluded within the Uruguay Round) has replaced the Tokyo Valuation Code, but there is no fundamental difference (this allow us to refer further to the Customs Valuation Code).

Customs valuation and transfer pricing methods Customs valuation is a fundamental concept for the assessment of customs duties and, together with the origin of goods and the nomenclature of the customs tariff, has been subject to specific agreement during multilateral free-trade negotiations.

Customs valuation is a process having as its final outcome the determination of the taxable base on which (*ad valorem*) customsduty rates are levied. Since there is no flexibility on the rate of applicable duty, it is obvious that any reduction of the taxable base — the customs value — would generate some

savings for the taxpayer (in our case, the importer). This is the main reason for the introduction of uniform customs-valuation rules in international trade agreements (although protectionist trade policies have also been to the fore).

The Customs Valuation Code provides for a preferred method — the transaction-value method — which should be generally accepted by customs authorities (in fact the value of goods agreed between parties with some adjustments regarding some transport-related costs). However, tax authorities may reject this method when the transaction takes place between related persons (similarly to the approach to transfer pricing).

As with the OECD transfer pricing approach (prior to the last change), where the transaction value (method) is not acceptable, other valuation methods may be used, in a prescribed hierarchical order, as follows:

- Transaction value of identical goods
- Transaction value of similar goods
- Deductive method (common aspects with the price-minus method)
- Computed method (cost-plus method)
- Fall-back method

The *transaction value of identical goods method* as the same philosophy as the comparable uncontrolled-price method used for transfer pricing purposes. For example, it may refer not only to internal comparables but mainly to external comparables, respectively transactions with goods for which the transaction value has been accepted by the customs authorities as a basis for assessment.

The difference between the first method and the *transaction value of similar goods method* mainly consists in the similarity (or identity) of the analysed features of goods with other goods whose customs value has previously been accepted by customs (assessed upon the transaction-value method).

Methods 3 (the deductive method) and 4 (the computed method) may be switched at the request of the importer only if the customs officers approve. They have been referred to in the past, as the *resale price* (price-minus) *method* and *cost-plus method*, which obviously suggest similarities to the OECD transfer pricing methods.

The fifth method is a residual method (last resort method) to be set independently by each state. In this case, it should be noted that the Valuation Code does not prescribe a method but lists those methods/principles that are not allowed to serve as the last-resort method.

Associated enterprises v related persons

The Customs Valuation Code uses the expression *related persons* (comparable to the affiliated persons used within the transfer pricing literature and regulations), and states that persons are to be deemed to be related only if:

- they are officers or directors of one another’s businesses

- they are legally recognised partners in a business
- they are employer and employee
- a third person directly or indirectly owns, controls or holds 5% or more of the voting stock or shares of both of them
- one of them directly or indirectly controls* the other
- both of them are directly or indirectly controlled by a third person or
- they are members of the same family.

It would be beneficial to note that the OECD Transfer Pricing Guidelines use an equivalent expression (associated persons) that includes:

- an enterprise of a contracting state participating directly or indirectly in the management, control or capital of an enterprise of the other contracting state, or
- the same persons participating directly or indirectly in the management, control or capital of an enterprise of a contracting state and an enterprise of the other contracting state.

Further, each state has defined its own understanding of what constitute associated enterprises (affiliated parties), since in most cases the expression *related persons* has a meaning consistent with the definition from the Customs Valuation Code.

Similarities and differences

When analysing cross-border transactions with goods it should be mentioned that customs valuation rules could conflict with the general transfer pricing rules. In many countries, provisions of international agreements have precedence over the national transfer pricing rules (but only with regard to customs duties and other import rights). Therefore, acceptance of the transaction value (price of goods) by the customs authorities would not guarantee the same for the purposes of transfer pricing between enterprises (unless this is specifically provided by the applicable transfer pricing regulation).

It is obvious that, beside the similarities mentioned above, there are many differences between transfer pricing rules used within the customs-valuation process and the transfer pricing rules set under the supervision of the OECD.

Firstly, it should be noted that customs regulations on valuation refer to individual transactions since transfer pricing covers the full range of transactions incurred between associated enterprises.

Further, the set of rules for customs valuation (including the specific transfer pricing rules) have been set through an international convention that also created an arbitration body

- the Customs Valuation Committee.

By contrast, in the case of transfer pricing rules (OECD Transfer Pricing Guidelines) the settlement of conflicts is subject to bilateral negotiation carried on according to the applicable double tax treaties (as a general rule).

As a conclusion, it is a challenge for practitioners to find common features and contact points between customs valuation and the OECD transfer pricing guidelines. Once they are found, new opportunities could arise for tax compliance and cross-border planning.

*) There is an Interpretative Note (to Article 15 of the Customs Valuation Code) stating that, for the purposes of the Customs Valuation Code, one person shall be deemed to control another when the former is legally or operationally in a position to exercise restraint or direction over the latter. The note also states that 'persons' includes a legal person, where appropriate.