

Full Federal Court decision in Chevron - 15 May 2017

Chevron Australia Holdings Pty Ltd v Commissioner of Taxation [2017] FCAFC 62 – Reinterpreting the arm's length principle

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Introduction

As noted in KPMG's earlier briefing on this matter on 21 April 2017, the Full Federal Court has given the Commissioner of Taxation another significant win in its ongoing battle with Chevron Australia in relation to the transfer prices it applied to certain cross-border related party loans. All three judges found for the Commissioner, dismissing Chevron's appeal.¹

The decision has implications not only for taxpayers with cross-border related party financial dealings but also taxpayers with any other cross-border related party dealings. It provides important insights into the approach that both courts and the Commissioner are likely to take when examining transfer pricing issues going forward, especially so in relation to the construction and application of the words 'might reasonably be expected' in Division 13 of Part III ITAA 1936 (**Division 13**).

The case concerns the transfer pricing implications of an intercompany loan agreement between CAHPL and its US subsidiary Chevron Texaco Funding Corporation (**CFC**) and whether the interest paid by CAHPL to CFC exceeded an arm's length price for the borrowing.

At first instance (*Chevron Australia Holdings Pty Ltd (No.4) v Commissioner of Taxation* [2015] FCA 1092), the Federal Court had found that Chevron Australia, based on the evidence led at trial, had not discharged the onus of proof that the amended assessments raised by the Commissioner under Division 13 and Subdivision 815-A ITAA 1997 (**Subdivision 815-A**) were excessive.

¹ *Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation* [2017] FCAFC 62, delivered on Friday 21 April 2017

The Full Court bench for the hearing comprised Chief Justice Allsop, and Justices Perram and Pagone. The Honourable Justice Pagone delivered the lead judgment, with Chief Justice Allsop and Justice Perram agreeing with Pagone J's reasons. Although Chief Justice Allsop provided his own reasons, they were prefaced with the statement that they were "*not intended to be by way of qualification*" to Pagone J's reasons.

Background

CAHPL challenged:

- The assessments made by the Commissioner pursuant to Division 13 in five income tax years from 2004 to 2008 (inclusive) ('**the relevant income years**'); and
- Those made by the Commissioner pursuant to Subdivision 815-A in three of those five years 2006 to 2008 (inclusive).

All assessments related to interest paid by CAHPL to CFC under an agreement between them dated 6 June 2003 titled a 'Credit Facility Agreement'.

The assessments were raised by the Commissioner on the basis that the interest paid by CAHPL, an Australian company, to its United States subsidiary, CFC, was greater than it would have been under an arm's length dealing between independent parties.

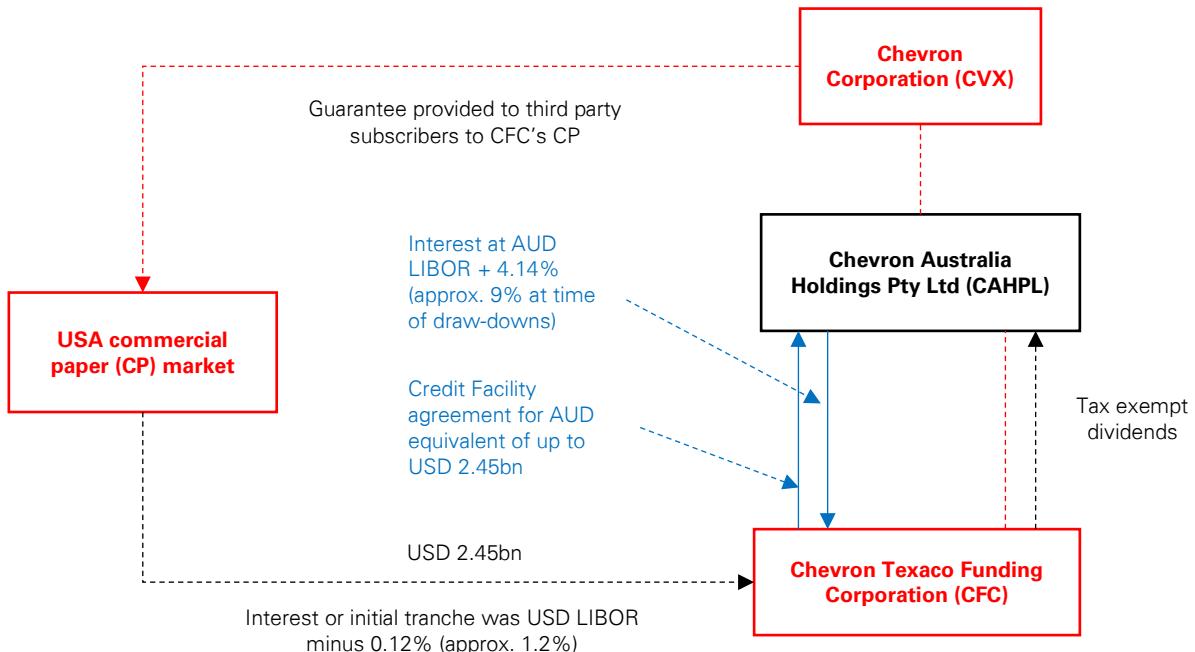
Chevron contended that the purpose of the Credit Facility Agreement between CAHPL and CFC was to effect an internal refinancing of an Australian currency debt of Chevron Australia Pty Ltd and to fund CAHPL's acquisition of Texaco Australia Pty Ltd.

In each of the relevant income years, CAHPL claimed tax deductions in Australia for the interest it paid to CFC, and returned as income the dividends it received from CFC as non-assessable non-exempt income pursuant to *s23AJ ITAA 1936*.

The following diagram illustrates the flow of funds associated with the Credit Facility Agreement and the funds raised by CFC in the U.S. commercial paper market.

Transaction diagram

After draw-downs on 6 June 2003 and 26 August 2003



Detailed analysis

KPMG has analysed the potential implications of the Full Federal Court's decision separately in relation to each of Australia's various transfer pricing laws.² The implications outlined below could potentially impact all taxpayers with international related party dealings (not just loans), both retrospectively and prospectively. Our analysis focuses on Division 13 as this was the approach taken by both the Federal Court and the Full Federal Court. This was because the Division 13 assessments covered the relevant years of income. If the Commissioner was successful in defending the Division 13 assessments, the Subdivision 815-A assessments did not, strictly speaking, need to be considered.

Division 13

The Full Federal Court's decision addressed three key aspects of Division 13: the meaning of the terms 'property', 'consideration' and 'arm's length consideration'. In addressing the concept of 'arm's length consideration', the Full Federal Court examined the objective standard of reasonable expectation and the hypothetical construct of the parties to the agreement being independent and dealing at arm's length with each other. Further, the Full Federal Court reviewed the finding of Robertson J at first instance that the currency of the loan obtained by CAHPL was an Australian dollar (AUD) loan rather than a United States dollars (USD) loan. These matters are considered below.

² Or purported transfer pricing laws according to the Commissioner of Taxation in relation to the Associated Enterprises Article of an applicable tax treaty. See *Chevron Australia Holdings Pty Ltd (No.4) v Commissioner of Taxation [2015] FCA 1092*.

The meaning of property

The Full Federal Court considered the definition of 'property' in ss136AA(1) in the context of the loan provided by CFC to CAHPL and concluded as follows:

"Property is defined to include services, and services is defined broadly to include any rights, benefits, privilege or facilities under an agreement for or in relation to the lending of money, and the ability to use funds without security, guarantee or charge may be spoken about loosely as a right, privilege, benefit or facility, but the absence of security, guarantee or other charge is more aptly seen as part of the consideration or price paid for the right, privilege, benefit or facility rather than as a right, privilege, benefit or facility itself. The relevant rights, benefits, privileges or facilities provided, or to be provided, to CAHPL under the Credit Facility Agreement in relation to the lending of money was the use of the funds advanced by way of loan and not the consideration paid or given for the use of the funds by way of loan.³

That is, it is only the rights, benefits, privileges or facilities that CAHPL actually obtained that can be considered as forming part of the relevant 'property' for purposes of ss136AA(1). The absence of things such as security, guarantees or other charges cannot be regarded as a right, privilege, benefit or facility obtained by CAHPL within the meaning of the term 'property' for purposes of ss136AA(1). In Pagone J's view, the lack of security was an absence in the consideration CAHPL was required to give for the funds it received from CFC rather than part of what it obtained. This led Pagone J to conclude that Robertson J was correct at first instance to identify the property as he did.⁴

The meaning of consideration

The term 'consideration' is relevant both with respect to:

- The consideration actually given or agreed to be given by CAHPL in respect of the loan of US\$2.5 billion; and
- The task of identifying what might reasonably be expected to have been given or agreed to be given in respect of the acquisition of a loan of US\$2.5 billion, had that loan had been acquired under an agreement between independent parties dealing at arm's length with each other.⁵

The Full Federal Court's analysis provides a clearer distinction between 'consideration' and "arm's length consideration", including how the former is used to inform conclusions regarding the latter. In the Full Federal Court's view, consideration is not to be construed narrowly and includes that given by the acquiring party so as to move the agreement whether in money or in money's worth. This is consistent with its meaning in a property conveyancing context, and importantly with the Commissioner's views expressed both in his submissions in the Federal Court at first instance,⁶ and in TR 94/14.

In Pagone J's view, the definition of consideration is broad enough to encompass all consideration relevantly given by the party receiving the property in respect of the acquisition whether paid to the transferor of the property or to a third party such as, in this case, hypothetically to the parent company upon the hypothesis of the payment of a fee.⁷

³ At [115].

⁴ At [117].

⁵ At [133].

⁶ At [83].

⁷ At [133].

The meaning of arm's length consideration

The Full Federal Court's discussion of the meaning of arm's length consideration, as defined in paragraph 136AA(3)(d), is detailed and inextricably linked with the hypothetical independent party construct (defined below) on which it is predicated. It addresses transfer pricing policy, interpretative matters and practical aspects of how the arm's length consideration should and should not be determined. The impact of the Full Federal's Court's reasoning with respect to both matters is likely to have a significant impact on how transfer pricing disputes are dealt with going forward.

According to the Full Federal Court, arm's length consideration for purposes of ss136AD(3) is to be determined by reference to the two criteria found in paragraph 136AA(3)(d), namely:⁸

- a) That the arm's length consideration meets the objective standard of being that which might reasonably be expected in relation to the acquisition; and
- b) That the standard of reasonable expectation be determined upon the hypothetical basis that the property had been acquired under an agreement in which the parties were independent and were dealing at arm's length with each other in relation to the acquisition (**hypothetical independent party construct**).

As Pagone J said, "the focus of the inquiry called for by these provisions is an alternative agreement from the one actually entered into where the alternative agreement was made by the parties upon the assumptions that they were independent and dealing at arm's length". "The task of ascertaining the arm's length consideration is fundamentally a factual inquiry into what might reasonably be expected if the actual agreement had been unaffected by the lack of independence and the lack of arm's length dealing."⁹

While the above statement seems simple, the practical application of this approach may not be quite so simple. We explore below the standard of reasonable expectation and the hypothetical independent party construct, both critical in determining an arm's length dealing.

The standard of reasonable expectation

According to the Full Federal Court, the standard of reasonable expectation found in the words 'might reasonably be expected' in paragraph 136AA(3)(d) calls for a prediction based upon evidence. The prediction contemplated by Division 13 involves an evaluative prediction of events and transactions that did not take place, and must be based upon evidence including admissible, probative and reliable expert opinion.¹⁰

Division 13 is intended to operate in the context of real world alternative reasonable expectations of agreements between parties and not in artificial constructs.

According to the Full Federal Court, the provisions of Division 13 are intended to operate in the context of real world alternative reasonable expectations of agreements between parties, not in artificial constructs. The Full Federal Court agreed with Robertson J that the purchaser (or in this case the borrower) may therefore be a company like CAHPL which is a member of a group, but where the consideration in respect of the acquisition identified in the hypothetical agreement is not distorted by the lack of independence between the parties or by a lack of arm's length dealings in relation to the acquisition.¹¹ Allsop CJ expressed this idea of real world alternative reasonable expectations in the following terms:

⁸ At [126].

⁹ At [126].

¹⁰ At [127].

¹¹ At [129].

*"But the ultimate purpose is to determine the consideration that would have been given (that is implicitly, by the taxpayer) had there not been a lack of independence in the transaction. How one comes to that assessment and the relationship between the posited arm's length dealing and what in fact occurred will depend on the circumstances at hand, and a judgment as to the most appropriate, rational and commercially practical way of approaching the task consistently with the words of the statutory provision, on the evidence available. ... Given the great variety of commercial circumstances to which the provision may apply, it would be wrong either to approach the interpretation of the provisions pedantically or to dictate a rigid or fixed approach to the task of determining the arm's length commercial consideration."*¹²

The hypothetical (arm's length) agreement should remain close to the actual agreement

It is the Full Federal Court's view that the standard of reasonable expectation requires an examination of the evidence to determine a reliably comparable agreement to that which was actually entered into. It also agreed with Robertson J that this exercise requires the hypothetical to remain close to the actual loan.¹³

The hypothetical independent party construct

Chevron submitted that the application of ss136AD(3) required pricing a hypothetical loan which a hypothetical CAHPL could obtain from a hypothetical independent party on the assumption that the hypothetical CAHPL had the attributes of the actual CAHPL but was otherwise independent. Pagone J rejected this proposition, noting that to apply ss136AD(3) in that way would be unrealistic and contrary to its purpose.¹⁴

The actual characteristics of the taxpayer must ordinarily serve as the basis in the hypothetical agreement

In Pagone J's view, the characteristics of the purchaser (the borrower in the case of CAHPL) for purposes of the hypothetical must be such as to meaningfully inform an inquiry into whether the consideration actually given under the agreement exceeded the arm's length consideration under the hypothetical agreement. Pagone J agreed with Robertson J's reasoning at first instance that in the hypothesis, the independent parties are to have the characteristics relevant to the pricing of the loan "to enable the hypothesis to work" and concluded that the actual characteristics of the taxpayer must, therefore, ordinarily serve as the basis in the comparable agreement.¹⁵

Pagone J also agreed with Robertson J that the hypothetical purchaser in this case need not be a standalone company, but was to be an oil and gas exploration and production subsidiary.¹⁶

Pagone J went further, indicating that his conclusions did not mean that all of the taxpayer's characteristics are necessarily to be taken into account, providing the decision in *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74 as an illustration of a feature of the taxpayer (namely that of having a history of incurring losses) being held not to be relevant to determining the arm's length price of an arm's length acquisition.¹⁷

¹² At [42].

¹³ At [128].

¹⁴ At [125].

¹⁵ At [128].

¹⁶ At [128].

¹⁷ At [128].

The prediction of what might reasonably be expected is not to be undertaken upon the hypothesis that CAHPL was not a member of the Chevron group or, as if it were an orphan

In the Full Federal Court's view, the ultimate object of the task required by Division 13 is to ensure that what is deemed as the consideration by ss136AD(3) is the reliably predicted amount which CAHPL might reasonably be expected to give or to have given by way of consideration rather than a hypothetical consideration without reliable foundation in the facts or reality of the circumstances of the taxpayer in question.¹⁸

Our observations

The Full Federal's Court's reasoning with respect to the hypothetical independent party construct is likely to have significant impact on many future transfer pricing cases involving Division 13, Subdivision 815-A and potentially also Subdivision 815-B. Our primary focus here is on Division 13 which the Full Federal Court focussed on, however, the latter two subdivisions are also discussed below in the 'Other Important Issues' section below.

Determining the property to be considered in the hypothetical agreement and the consideration to be given by an independent lender in CAHPL's case

CAHPL contended that the property to be considered in the hypothetical agreement was a loan without security or covenants given by a commercial lender to a borrower such as CAHPL. As is evident from the above discussion, the Full Federal Court rejected this submission. In the Full Federal Court's opinion, the property to be considered in the hypothetical agreement was a loan of US\$2.5 billion for a term of years. What CAHPL obtained were the rights, benefits, privileges and facilities of a loan of US\$2.5 billion in accordance with the Credit Facility Agreement for a number of years for a consideration which did not require it to give security.¹⁹

For purposes of answering the question as to what the consideration that CAHPL, or a borrower in its position, might reasonably be expected to have given to an independent lender, the Full Federal Court placed significant weight on the fact that it was Chevron group policy that Chevron Corporation (**CVX**) in California ultimately decided all matters concerning internal restructures, including the extent to which subsidiaries were financed by debt or equity and that an objective of the group was to obtain the lowest cost of funding to the group for external borrowing.²⁰ The Full Federal Court agreed with Robertson J at first instance that an independent borrower like CAHPL dealing at arm's length would have given security and operational and financial covenants to acquire the loan obtained by CAHPL.

Our observations

The Full Federal Court's approach clearly underlines the context within which the arm's length consideration for a transaction of this type should be determined and the importance of supporting the position adopted with clear commercial and market-based evidence.

Arguably, another key aspect of this analysis is the level of debt that is taken on by the borrower. The level of debt and capital is an aspect of the arm's length analysis that would directly impact the credit rating of the borrower and in turn the consideration for the loan. Although not specifically addressed in the Chevron decision but consistent with the ATO's ruling TR 2010/7 (which applied in respect of Division 13 and deals with the interaction of thin capitalisation & transfer pricing) KPMG recommends being able to show what an arm's length level of debt and capital for the borrower would be for transfer pricing purposes notwithstanding the statutory thin capitalisation safe harbour limit. Further, this arm's length capital structure for the borrower should then be used in the analysis to support the interest rate on the loan.

¹⁸ At [130].

¹⁹ At [131].

²⁰ Pagone J at [132]; Allsop CJ at [62].

Guarantee fee

An important aspect of the Full Federal Court's decision was the court's statement that in determining arm's length consideration for purposes of Division 13, that amounts which could be shown on the evidence as reasonably likely to have been given by independent parties in comparable dealings could be taken into account, irrespective of whether such consideration was actually given by the taxpayer.²¹ The example given in the decision is particularly interesting; that is, that a guarantee would have been given by CVX to enable CAHPL to borrow at a cheap(er) rate. However, in CAHPL's case, no evidence was led to enable the court to reach a conclusion about the quantum of a guarantee fee that might reasonably have been expected to have been paid by CAHPL as part of the consideration for the hypothetical loan.

Our observations

This aspect of the decision can be very important to the outcome of a transfer pricing dispute of this nature. In particular, exploring this area has a number of potential benefits for taxpayers where they are able to positively establish, via evidence, the following:

- 1) That independent parties in comparable dealings would be reasonably likely to have given such consideration (e.g. a guarantee fee); and
- 2) The monetary value of such consideration.

The decision in Chevron does not provide guidance as to how the monetary value of the guarantee fee might be determined.

If a guarantee position is relevant to an analysis of the arm's length consideration for a transaction of this type, and depending on individual facts and circumstances, it may be beneficial to use methods described in the OECD's Transfer Pricing Guidelines to determine the arm's length value of a guarantee fee. KPMG understands that the ATO is looking closely at this aspect of the Chevron decision.

Proper currency of the loan

At first instance, Robertson J had held that there could be no doubt that the currency of the Credit Facility was AUD²² and that the currency of a loan between independent enterprises dealing wholly independently with one another was (based on the evidence before the court) also in AUD.²³ The Full Federal Court decision spends little time dealing with the difference between the parties concerning (i) the proper currency of the loan from CFC to CAHPL; and (ii) the proper currency of the hypothetical (loan) agreement. Pagone J held that there was no reason to depart from Robertson J's finding that the proper currency of the loan from CFC to CAHPL was AUD, and that the hypothetical agreement might reasonably have been expected to be in AUD.²⁴

Our observations

The question of the currency of the hypothetical loan is often the subject of disagreement in transfer pricing disputes with the ATO. Going forward, taxpayers will need to ensure they have robust, compelling evidence to support a reasonable expectation as to what the proper currency of the hypothetical loan should be.

²¹ At [133].

²² At [302].

²³ At [583].

²⁴ At [134].

Other important issues

Subdivision 815-A

In summary, the Full Federal Court stated that the independent enterprise based analysis which Subdivision 815-A required to be undertaken is akin to the hypothetical independent party construct in Division 13.²⁵ The Full Federal Court concluded that Robertson J was correct to assume, on the available evidence, that what might be expected to operate between independent enterprises dealing wholly independently with each other was a loan by CAHPL with security provided by its parent at a lower interest rate.

Constitutional validity of Subdivision 815-A

Chevron submitted that Subdivision 815-A was constitutionally invalid on a variety of grounds but principally on the basis that the enactment of Subdivision 815-A with retrospective effect was beyond the constitutional power of the Commonwealth because it imposed an arbitrary and incontestable tax. The Full Federal Court dismissed CAHPL's submissions in this regard.²⁶

The Commissioner can defend assessments on alternative bases

Chevron submitted that assessments could not be made under Subdivision 815-A for years of income for which determinations under Division 13 had also been made. The Full Federal Court rejected this submission, holding that the efficacy of an assessment pending an appeal does not prevent the existence of an alternative basis upon which the decision may be defended by the Commissioner in the appeal by alternative determinations.²⁷

Potential implications for Subdivision 815-B

At first glance, it may appear that the Chevron case could potentially inform how Subdivision 815-B might be applied, for example, the hypothetical independent party construct is expressed in *ss815-125(1)* of Subdivision 815-B in the following words: "the conditions that might be expected to operate between *independent entities dealing wholly independently with one another* in comparable circumstances". This closely compares to the wording in Subdivision 815-A. Further, both Subdivision 815-A and 815-B are based on the concept of a taxpayer getting a transfer pricing benefit. It is, however, relevant to note that the way in which the transfer pricing benefit is determined, is different in the two sets of provisions.

The Associated Enterprises Article of an applicable tax treaty

The Commissioner was unsuccessful before the Federal Court at first instance in arguing that the Associated Enterprises Article of the Australia/US tax treaty provided a separate and independent basis upon which to support the amended assessments.²⁸ The Commissioner did not appeal against this aspect of Robertson J's decision.

Why then is this still relevant? It remains relevant because it is unclear whether the Commissioner accepts the decision at first instance in this regard. It is hoped that when the Commissioner's Decision Impact Statement is issued in relation to the Chevron Full Federal Court decision, it will clearly indicate acceptance by the Commissioner of Robertson J's decision on this point. Or, alternatively, that it will clearly articulate the Commissioner's reasons for not accepting Robertson J's decision and outline for taxpayers the approach the Commissioner intends to take in future cases, including those where Subdivision 815-B applies.

²⁵ At [156].

²⁶ At [144]-[145].

²⁷ At [149].

²⁸ At [61].



What you should do – Our recommendations

The importance of having comprehensive, relevant commercial and economic evidence to support transfer prices of related party transactions was emphasised by Robertson J at first instance, and again highlighted in the Full Court's decision. Our recommendations are aimed at helping taxpayers to assess if they would satisfy the evidentiary burden of proof that the Commissioner applies when reviewing or auditing related-party transactions.

Cross-border related party dealings - financial

With respect to historic cross-border related party financial dealings, we recommend a two-stage approach be followed to review these dealings in light of the Chevron decision and in particular, how the decision may impact your businesses' particular facts and circumstances.

Stage 1: Preliminary Analysis of past arrangements having regard to:

- Materiality of interest claimed as an income tax deduction;
- Currency of loan used;
- Whether the credit rating of the Australian borrower was significantly less than the credit rating of the MNE group. In particular, this issue may relate directly to the level of gearing of the entity which is separately considered for transfer pricing purposes;
- Whether the credit spread was significantly larger than external borrowing costs of MNE group; and
- For US-based MNEs, consider potential FIN 48 considerations.

If the preliminary analysis determines that there is an unacceptable level of tax risk, we recommend proceeding to a Stage 2 review (below). In the event that the preliminary review indicates that there is an acceptable level of tax risk, the preliminary analysis will assist in obtaining internal sign-off consistent with internal governance processes.

Stage 2: Detailed Review. If the Stage 1 preliminary analysis identifies an unacceptable level of tax risk, we recommend:

- An objective examination of the Terms and Conditions of the dealings to ascertain whether they are consistent with those that independent parties might reasonably be expected to have agreed to;
- A review to determine whether the level of debt of the borrower can be supported, with reference to evidence, on arm's length grounds;
- An assessment of whether the hypothetical independent party construct that has been used is consistent with the approach (but not necessarily the outcome, as each matter will depend on its own set of facts and circumstances) in Chevron. This will, among other things, generally require an analysis of the arm's length level of debt regardless of the Thin Capitalisation position adopted;
- A review of the available documentary and oral evidence (including the borrowing policies of the Group, commercial and expert evidence), and an objective assessment of the level of support provided by that evidence for the currency of the loan;
- Assistance to gather additional evidence to further support the pricing adopted and to meet the 'reasonable expectation' test; and
- An examination of the comparables used, and an assessment of whether they meet the level of comparability that the Full Federal Court has indicated is required.



Cross-border related party dealings - non-financial dealings

With respect to historic cross-border related party dealings other than financial dealings, we recommend the following approach be followed to review these dealings in light of the Chevron decision. This approach will, of course, need to be tailored to the particular facts and circumstances of each case.

Review past arrangements having regard to:

- Materiality of income tax deduction claimed;
- An examination of the Terms and Conditions of dealings to ascertain whether these are consistent with those that independent parties might reasonably be expected to have agreed to;
- Examine whether the hypothetical independent party construct that has been used is consistent with the approach (but not necessarily the outcome, as such matters depend on the facts) in Chevron;
- Examine whether comparables used are sufficiently comparable having regard to guidance in Chevron; and
- For US-based MNEs, consider the potential FIN 48 considerations.

If the objective analysis of the level of tax risk is considered acceptable and supported by evidence, document the conclusion reached and obtain the internal sign-off consistent with internal governance processes.

If more detailed analysis of level of tax risk is considered unacceptable (i.e. medium to high risk), determine an appropriate strategy in order to manage and mitigate any risk.

Final thoughts

Special leave application to High Court?

It is not yet known if Chevron will file a special leave application with the High Court, however, given the amount of tax involved, the money spent to date, and the potential wider implications for Chevron with respect to its other cross-border related party debt funding arrangements²⁹, a special leave application would not be a surprise. If Chevron does seek special leave, the Application is due to be filed on or before 19 May 2017.

Forthcoming ATO interpretative guidance and practical compliance guidance

The ATO is due to release a draft Practical Compliance Guideline (**PCG**) this month for consultation in relation to the ATO's compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions.

The ATO is also due to release by 31 July 2017 draft taxation rulings dealing with the interaction of the transfer pricing rules and the thin capitalisation rules and inbound and outbound interest-free loans.

²⁹ Refer to Chevron's submission to the Senate Economics References Committee's Corporate Tax Avoidance Inquiry (Submission 121), page 8.



Global impact

This case could have far reaching consequences for multinational enterprises as it may create an international precedent for the approaches of revenue authorities and courts around the world in relation to determining the characteristics of hypothetical independent enterprises for purposes of the associated enterprises article of tax treaties and domestic transfer pricing rules. As such, it would be useful for many multinational enterprises to review their global arrangements with an eye to this possibility.



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