TR 2010/7EC - Compendium

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On 8 April 2024, the *Treasury Law Amendment (Making Multinationals Pay Their Fair Share - Integrity and Transparency) Act 2024* was enacted. The amendments apply to assessments for income years commencing on or after 1 July 2023, with the exception of new integrity rules (debt deduction creation rules) which apply in relation to assessments for income years starting on or after 1 July 2024.

Under the new thin capitalisation rules:

- the newly classified 'general class investors' will be subject to one of 3 new tests
  - fixed ratio test
  - group ratio test
  - third party debt test
- financial entities will continue to be subject to the existing safe harbour test and worldwide gearing test or may choose the new third party debt test
- ADIs will continue to be subject to the previous thin capitalisation rules
- the arm's length debt test has been removed for all taxpayers.

ADIs, securitisation vehicles and certain special purpose entities are excluded from the debt deduction creation rules.

Entities that are Australian plantation forestry entities are excluded from the new rules. For these entities, the previous rules will continue to apply.

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Ruling Compendium – TR 2010/7

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This is a compendium of responses to the issues raised by external parties to draft TR 2009/D6 – Income tax: the interaction of Division 820 of the *Income Tax Assessment Act 1997* and the transfer pricing provisions in relation to costs that may become debt deductions, for example, interest and guarantee fees

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

(Summary of issues raised and responses)

Issue No.	Issue raised[1]	ATO response/action taken[2]
1	***The examples in the ruling should more clearly illustrate***	

[1] Unless otherwise noted, references are to examples and paragraphs in the draft Ruling, TR 2009/D6.
[2] Unless otherwise noted, references are to examples and paragraphs in the final Ruling, TR 2010/7.

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	the principles in the ruling. Example 1 deals with the situation where Aus Co's debt level ($400m) is above the Div 820 safe harbour ($375m) and is also above the level that an independent lender would be prepared to lend ($334m). The example concludes that 'The transfer pricing provisions would not be applied to deny additional debt deductions by adopting a higher excess debt amount and because the actual interest rate does not exceed the arm's length rate.' The aspect that I'm unclear on is the reference in this sentence to the interest rate not exceeding the arm's length rate. It would seem that on the assumed facts 10% is an arm's length rate on $334m but not on $375m. Is the position then that one would work out the arm's length rate on the arm's length level of debt (that is, on the $334m) and apply that rate to the lower of the actual level of debt ($400m) and the Div 820 safe harbour amount ($375m)? Example 2 could lull taxpayers and advisers into a false sense of security by thinking that the ATO would generally accept 3:1 as being an arm's length debt amount. In point of fact, we understand that in a number of cases that ATO is likely to conclude that a 3:1 level of gearing is not what parties dealing at arm's length would do and absent CUPs or other methodologies the ATO would resort to the indirect methods referred to in paragraph 27. We request that the draft Ruling include an example illustrating the guidance provided in paragraphs 28-36 in the case where Aus Co is not able to borrow the whole amount of related party debt from unrelated parties and the ATO considers that the interest rate paid by Aus Co is more than the arm's length consideration. In our view, Example 2 simply illustrates the position addressed in Part E of TR 92/11 and the view expressed in paragraph 1.78 of the EM to Div 820 and is therefore of limited value.	Refer to paragraphs 13 to 31 of the final Ruling. Example 1 in the draft Ruling was intended to illustrate that the transfer pricing provisions cannot defeat the operation of the thin capitalisation provisions. Accordingly, in the example the arm's length rate of interest of 10% was applied to the total debt (that is, the 'adjusted average debt') of Aus Co of $400m, giving an otherwise allowable amount of debt deductions of $40m, before applying the thin capitalisation provisions in Division 820. Example 2 in the draft Ruling addressed a situation where a borrowing company did not have any 'excess debt' for the purposes of the thin capitalisation provisions. However, its debt was priced in excess of the arm's length price. Here the transfer pricing provisions would apply and the ATO could reduce the amount debt deductions claimed by Aus Co to the arm's length consideration. Division 820 would have no application because the level of cost bearing debt was within the statutory 'safe harbour debt amount'. In the light of the feedback received, the Examples in the final Ruling have been amended and additional examples have been inserted, to provide greater clarity – see paragraphs 13 to 31. In particular, new Example 4 in the final Ruling addresses a scenario where, after considering all arm's length pricing methods and taking account of all the necessary elements of comparability, it is not possible to ascertain the arm's length consideration in respect of the relevant acquisition, there being no evidence that similar arrangements would have been entered into between unrelated parties. In such a case one possible option, though not the only option, might be to price the amount of debt by having regard to the amount of debt that the taxpayer would reasonably be expected to have if it was dealing at arm's length with other parties. We consider this is one method that the Commissioner could use to work out the appropriate interest rate to be applied to the actual debt of the taxpayer, as a means of determining an arm's length consideration for the transactions actually entered into by the taxpayer. Other approaches may be equally valid, depending on the facts and circumstances of the case.
2	***Interaction of Division 820 and the transfer pricing***	

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	provisions Most corporate taxpayers have operated on the basis that the safe harbour was a true safe harbour. That is, taxpayers could be confident that if their level of gearing was less than the safe harbour debt amount they could operate on the basis that the ATO would not question the quantum of such gearing. Further, they could also be confident that the pricing of such debt should be based on the actual amount borrowed and not some notional 'arm's length' debt amount. The taxpayer's interpretation is supported by a comment made in the tax ruling that to do otherwise would be to 'defeat the operation of Division 820 which allows an entity in the course of determining whether its debt levels are excessive to select a 'statutory safe harbour debt amount'. Based on this comment, it would appear more than reasonable for a taxpayer to assume that if a debt level was not excessive (that is, it was less than the safe harbour debt threshold) then such amount would also be an arm's length amount of debt and hence the appropriate level of debt to be priced. The better view in our opinion is that Parliament has deliberately removed the arm's length principle from the question of gearing and provided bright line statutory tests for allowable debt. The arm's length price should be calculated with reference to that debt and not to some theoretical lower 'arm's length' amount of debt. We do not agree that the suggested approach accords with the scheme of the Act, the statutory purposes of the Divisions or gives effect to policy intent. The ruling should be amended to clearly state what appears to be the key element of the ATO's position that is, Division 13 can be applied to determine an arm's length interest on a notional arm's length amount of debt that is lower that the actual amount of debt, this is notwithstanding that the actual amount of debt falls within the Division 820 safe harbour and the interest rate so determined will be applied to the actual	Refer to paragraphs 9 to 12 and 62 to 72 of the final Ruling. The thin capitalisation rules and the transfer pricing regime have different functions and operate independently. The thin capitalisation regime is concerned with ensuring that the Australian revenue base is not eroded by excessive interest deductions borne by taxpayers who have international owners or operations. It disallows debt deductions which would otherwise be deductible, with the disallowed amount determined by reference to the 'excess debt' owed by a taxpayer. Importantly, the thin capitalisation regime does *not* prescribe the level of gearing an entity should adopt for other purposes. The proposed view suggests that, because Division 820 limits a 'debt deduction' by reference to an entity's capitalisation, it is this level of capitalisation that must be used for the purposes of applying the arm's length principle in Division 13 or the Associated Enterprises Articles of Australia's tax treaties. Therefore, if there is no Division 820 'excess debt' then the actual capitalisation or gearing *must* be used for the purpose of applying the transfer pricing provisions to determine the arm's length price of the costs. We consider that this view is not consistent with the wording within either section 136AD of Division 13 or Division 820, nor does it have any support in the associated explanatory memoranda. It attempts to use the statutory safe harbours found throughout Division 820 as an approximation for arm's length behaviour, thereby effectively denying an examination of whether the consideration given for an associated enterprises loan is an arm's length amount. The existence of a 'safe harbour debt amount' under Division 820 for a taxpayer is not relevant to the determination of an appropriate transfer pricing method or its application. As set out at paragraphs 9 to 12 of the final Ruling, the key element of the ATO's position is that the transfer pricing provisions are not prevented from operating by the thin capitalisation provisions. The key points emerging from the final Ruling are: • The transfer pricing provisions are not prevented from operating by the thin capitalisation provisions. • In pricing cross-border debt, the approaches laid out in our earlier Taxation Rulings should be followed (Taxation Rulings TR 92/11 and TR 97/20 are most relevant). Those Rulings generally contemplate the use of traditional methods or profit methods to work out an arm's length consideration. • Consistent with those Rulings, there may be some cases that cannot be

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	amount of debt. We request that Alternative view 2 from TD 2007/D20 (that is, paragraphs 32-33) should be included in this section of the draft Ruling as it represents the critical issue in the context of the policy and interpretative issues arising out of the draft Ruling.	priced using the usual approaches. These will typically be cases where the debt arrangements in question do not make commercial sense and so similar arrangements cannot be found as comparables. In those cases (which would usually be those within the scope of subsection 136AD(4) of the *Income Tax Assessment Act 1936* or a relevant tax treaty article), the Commissioner will need to determine an arm's length consideration on some rational basis.
3	***Arm's length amount of debt*** According to the draft ruling it is necessary, in order to satisfy the arm's length test in Division 13 for purposes of pricing and in accordance with the policy intent and purpose of the legislation, to first determine an arm's length amount of debt. Determining an arm's length amount of debt under Division 13 is contrary to the policy intent of the thin capitalisation rules. The approach proposed in the Ruling is also inconsistent with the policy objective to minimise compliance costs as stated in paragraph 11.11 of the EM. Expecting taxpayers to evaluate the arm's length rate of interest under Division 13, even when its level of debt capital is within the safe harbour clearly undermines the intended purpose of the safe harbour and will impose a significant additional compliance burden on taxpayers. As a minimum the ATO should implement administrative practice(s) to mitigate the additional compliance burden on the taxpayer. The determination of an arm's length amount of debt for purposes of application of the transfer pricing provisions as proposed in the Ruling rather than applying the transfer pricing provisions on the basis of the actual debt that a taxpayer has diverges from accepted practice in the interpretation of the arm's length principle as set out in the OECD's *'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations'*, in particular paragraph 1.36. Requiring determination of an arm's length amount of debt, which is a notional rather than actual amount, may be	The draft Ruling did not require a taxpayer to work out an arm's length amount of debt to demonstrate that the pricing of their debt is consistent with the transfer pricing provisions. However, to ensure that this is clear, the final Ruling specifically provides that it does not require a taxpayer to work out an arm's length amount of debt to demonstrate that the pricing of their debt is consistent with the transfer pricing provisions (paragraphs 59 to 61). Consistent with the Commissioner's views set out in Taxation Ruling TR 97/20, the arm's length principle requires that the pricing of a taxpayer's associated enterprise dealings should make commercial sense in all of the circumstances of the case (including the taxpayer's gearing and financial position, cost structure, business strategies and prevailing market and economic conditions, see paragraphs 2.15 to 2.17 of Taxation Ruling TR 97/20). For example, it may not make commercial sense in all the circumstances if financing expenses from an associated enterprise loan were so significant that operating with these costs was not commercially viable or did not leave a commercially realistic return for the functions performed, assets used and risks assumed in the relevant business activities. It is only in those circumstances that the Commissioner will need to look beyond the usual transfer pricing methods. That he will need to do that in some cases is explicitly contemplated by both Taxation Rulings TR 92/11 and TR 97/20.

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	problematic from the perspective of the tax authority in the jurisdiction of the related party lender. It appears possible that Mutual Agreement Procedures (MAP) may be more easily frustrated and could give rise to greater incidences of double taxation where the other taxation authority does not recognise an adjustment determined on the basis of notional transactions. The ruling does not provide any practical guidance on how taxpayers should determine the arm's length amount of debt. The ruling provides no guidance as to the analysis that the ATO would expect a taxpayer to undertake to determine the arm's length debt amount for the purposes of applying Division 13. Clear practical guidance is required to ensure that both taxpayers and ATO field officers have a clear understanding as to what is required, without such guidance the Ruling is of little value.	
4	***Determining the arm's length amount of debt*** Working out the arm's length amount of debt: 1. is unworkable in practice, there are other effective ways of preventing excessive debt deductions, but without the attendant uncertainty and compliance costs. 2. for the purposes of the transfer pricing provisions, is inconsistent with the clearly stated policy objective to minimise compliance costs as stated in paragraph 11.11 of the EM. 3. for purposes of application of the transfer pricing provisions as proposed in the Ruling rather than applying the transfer pricing provisions on the basis of the actual debt that a taxpayer has diverges from accepted practice in the interpretation of the arm's length principle as set out in the OECD's *'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations'*, in particular paragraph 1.36. 4. which is notional rather than the actual amount appears to be a key element of the ATO's position so should be	As emphasised above, the draft Ruling did *not* require a taxpayer to work out an arm's length amount of debt to demonstrate that the pricing of their debt is consistent with the transfer pricing provisions. Nor does the draft Ruling nor the final Ruling mandate any particular approach to the pricing of that debt. This is made clear in paragraphs 59 to 61 of the final Ruling. Consistent with Taxation Ruling TR 97/20, the draft Ruling and final Ruling provide that it is necessary only to show that a taxpayer's associated enterprise debt arrangements reflect a commercially realistic outcome. Taxation Rulings TR 92/11, TR 94/14, TR 97/20, TR 98/11 and TR 1999/1 together form a complementary suite of rulings on the application of the transfer pricing provisions which incorporate the internationally accepted arm's length principle to determine the arm's length consideration. We consider that there is no inconsistency between the draft Ruling and final Ruling and the OECD TP Guidelines and OECD Model Commentary. We acknowledge that the OECD TP Guidelines state that the examination of transactions should be based on the transactions actually undertaken (paragraph 1.36). However, the OECD TP Guidelines go on to state that tax administrations may disregard actual transactions or substitute other transactions for them in exceptional circumstances. One such

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	clearly stated. 5. requires practical guidance from the ATO on how this should be done. 6. imposes an additional compliance burden so the ATO should implement administrative practice(s) to mitigate this burden. Whilst it is intuitive to say that an independent entity would seek to gear itself to maximise its earnings, it remains a theoretical construct. The gearing of an independent entity will depend on a multitude of factors, not the least its long term business strategy and the shareholders' appetite for risk. Such factors are not measurable through transfer pricing approaches and the arm's length range would be so wide as to be meaningless. At any point in time the ease of access to third party funding will vary enormously and risk premiums will fluctuate considerably. In addition, lenders' appetite to lend to an entity may vary considerably between lenders, depending on a multitude of factors.	example the OECD TP Guidelines provides as an exceptional circumstance is an investment in an associated enterprise in the form of an interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way (paragraph 1.37). Thus, the OECD accepts that transfer pricing arm's length principles do allow for the reconstruction of transactions in terms of the characterisation of transactions, such as whether an amount is in substance debt or equity. This view is also supported by the OECD Model Commentary on the Associated Enterprises Article, Article 9, which states at paragraph 3. b): the Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital; Applying the OECD TP Guidelines and OECD Model Commentary requires the establishment of the arm's length price, which may require the application of an arm's length capital structure. The possible approach suggested in both the draft Ruling and final Ruling outlines the establishment of the arm's length price and then applies this price to the actual amount of debt transacted. The approach is on the basis that it enables an effective application of the transfer pricing rules whilst, at the same time, maintaining the integrity and policy intent of Australia's thin capitalisation provisions. With regard to the final point about gearing, we accept that capital structures vary across firms and industries and are dependent on both market conditions and internal strategic business decisions. Market conditions impact the ability of entities to raise capital and also their appetite for leverage, that is, whether to issue debt or equity. In addition, a situation specific only to a particular entity may impact what form of capital that entity uses. Further, lenders may not be prepared to advance debt funding to particular industries or businesses, or the market as a whole may consider that a particular industry has no further tolerance to debt funding. Also, the higher the level of debt funding of a borrowing entity the more risky the entity is and capital markets will tend not to lend to an enterprise that is inadequately capitalised having regard to the risks of its business and industry. Paragraph 1.30 of the OECD TP Guidelines notes that arm's length prices may vary across different markets even for transactions involving the same property.

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		We also acknowledge that the determination of an arm's length consideration involves an element of judgment and is not a precise science. Applying the arm's length principles requires some flexibility to produce a result that reflects the underlying purpose of the statutory provisions (refer paragraphs 74 and 323 of Taxation Ruling TR 94/14 and paragraph 1.1 of Taxation Ruling TR 97/20). However, as paragraph 1.22 of Taxation Ruling TR 97/20 states, there is a need to find an answer for all transfer pricing problems. Further, paragraph 4.28 of Taxation Ruling TR 98/11 states that: > Representations have been made to the ATO that, in the reality of business life, there are many situations where comparable pricing information is inadequate or unavailable. It is accepted that availability of information may impose a constraint on a taxpayer in selecting and applying an appropriate arm's length pricing methodology in some circumstances. However, there is still a need to ensure an appropriate return to the Australian taxpayer having regard to the functions it performs, the assets it uses and the risks that it bears, the Australian economic and market conditions, and the need to find an answer for all transfer pricing problems (see paragraphs 3.88 to 3. 99 of TR 97/20).
5	***Parental affiliation*** The views on the concept of 'parental affiliation' are at odds with the arm's length principle, but in any event, the ruling would benefit greatly from practical guidance on how the ATO envisages the issue of affiliation being taken into account.	The ATO disagrees. See paragraph 49 of the final Ruling. We consider that taking account of parental affiliation is consistent with the arm's length principle embodied in the transfer pricing provisions where, in determining the creditworthiness of a borrower, it is a feature of the market to take account of any affiliation the borrower has.
6	***Period of application*** The ruling should be applied prospectively only as it would be unjust and inappropriate if the ruling applied retrospectively	The ATO remains of the view that the Ruling should apply before and after its date of issue. Paragraphs 75 to 82 of the final Ruling have been inserted to address this issue in detail.
7	***Tax treaties*** The Ruling should address the issue of whether the grant of power to amend assessments in reliance upon the Associated Enterprises Article of an applicable tax treaty given to the Commissioner under subsection 170(9B) of the ITAA 1936 is constrained or unconstrained.	The ATO considers that this is beyond the scope of this Ruling which is to address the interaction between the thin capitalisation provisions and the transfer pricing provisions and accordingly has not expanded the final Ruling to cover this. We have, however, in the final Ruling restated our long held view that an adjustment applying the arm's length principle to the pricing or profit allocation in respect of a taxpayer's international dealings is authorised on the basis of Australia's transfer pricing provisions in Division 13 and the related treaty provisions. We also noted that

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		the proposition that there is a power to assess in reliance on the Associated Enterprises Articles in Australia's treaties received favourable comment, in *obiter*, from the Federal Court (Middleton J) in *SNF (Australia) Pty Ltd v Commissioner of Taxation* (paragraphs 39 to 42)
8	***Scope of Division 13*** The Ruling should address the scope of Division 13 taking into account the intended scope when it was enacted, whether the scope of Division 13 was affected by the enactment of Division 16F and Division 820 and include an alternative view that the scope of Division13 is not as wide as described in the Ruling. There is nothing in the Division 13 EM to suggest it was Parliament's intention that the transfer pricing rules in Division 13 were: (1) broad enough to address the matter of whether a taxpayer's capital structure was arm's length or not; and (2) able to use a notional arm's length amount of debt for purposes of determining the arm's length interest rate on a cross-border related party loan.	The ATO considers that addressing the scope of Division 13 in depth is well beyond the scope of this ruling. Taxation Ruling TR 94/14 addresses in depth the scope of Division 13, taking into account the history of the Division and the intended scope when it was enacted. In particular, please see paragraphs 154-186 and 278-352 of Taxation Ruling TR 94/14. Note also that Taxation Ruling TR 92/11 specifically addresses the application of Division 13 to loan arrangements and credit balances. With regard to the scope of Division 13 in relation to associated enterprises loans, including a taxpayer's capital structure and thus an arm's length amount of debt, refer to subparagraphs 60(d) and (g) of Taxation Ruling TR 92/11. We accept that the Division 13 Explanatory Memorandum did not specifically address the issue raised, although it did specifically address the possible application of Division 13 to cross-border related party loans. The relevance of a taxpayer's debt and capital structure is explained at paragraphs 51 to 58 of the final Ruling.
9	***Inconsistent with other Taxation Ruling*** The Ruling is inconsistent with TR 2001/11, in particular paragraphs 3.41 to 3.45. The Ruling is also inconsistent with TR 2005/11, in particular paragraphs 10, 34 and 40.	With respect we disagree. We can see no conflict between the draft Ruling and Taxation Ruling TR 2001/11. The final Ruling examines the interaction between the transfer pricing provisions and the thin capitalisation provisions in the context of an associated enterprises loan under an 'international agreement'. Taxation Ruling TR 2001/11 considers the operation of Australia's permanent establishment attribution rules to non-financial institutions. Paragraphs 3.41 to 3.44 of Taxation Ruling TR 2001/11 address the attribution of interest expense within a single legal non-financial entity, which must be in accordance with the arm's length principle (refer subsection 136AE(7) of Division 13 and the Business Profits Articles of Australia's tax treaties). In this context, paragraph 3.45 of Taxation Ruling TR 2001/11 provides that, when allocating income and deductions through the arm's length separate enterprise principle, it is important to recognise that an independent enterprise could not operate without adequate equity

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		capital. Accordingly, an appropriate level of such capital must be allocated to a permanent establishment. In addition, we do not see any conflict between the draft Ruling and final Ruling and TR 2005/11. Taxation Ruling TR 2005/11 deals with income tax issues related to the funding of a permanent establishment (PE) of a multinational bank. It specifically focuses on such issues arising where a bank internally transfers funds to or from a PE in the ordinary course of carrying on business through that PE. Such a transfer of funds is referred to in this Ruling as an interbranch funds transfer. Paragraphs 10 and 40 of Taxation Ruling TR 2005/11 provide that Division 820 is intended as an exclusive code for the matters with which it deals, that is, the limiting of debt deductions by reference to the levels of debt and equity capital of the entity. Accordingly, if an ADI passes the relevant safe harbour test in Division 820, Australia's permanent establishment attribution rules will not be used to adjust the gearing even if the level of equity capital of the bank's Australian operations is less than an arm's length amount. Paragraph 41 of Taxation Ruling TR 2005/11 provides that Division 820 does not prevent the application of Division 13 of Part III of the ITAA 1936 and comparable tax treaty provisions where the pricing of a loan is not arm's length. In the context of a permanent establishment this includes the application of Australia's attribution rules to the pricing of an interbranch loan that is recognised for the purposes of attributing a bank's income and expense or profit (for example, interest rates). See also paragraphs 9 and 13 of Taxation Ruling TR 2005/11.
10	***Subsection 136AD(4)*** The Commissioner is requested to clarify the application of subsection 136AD(4) and in particular to confirm that where the information and evidence used by a taxpayer is based on the best available third party information, the Commissioner will not completely disregard this information when applying subsection 136AD(4). Pricing debt is intuitively an area where there is clearly sufficient information to establish the arm's length price without the Commissioner having to resort to subsection 136AD(4). The policy underlying the application of subsection 136AD(4)	The application of subsection 136AD(4) may occur where for any reason it is not possible or practicable for the Commissioner to ascertain the arm's length consideration in respect of an acquisition of property (paragraph 38 of the final Ruling). We note that the application of subsection 136AD(4) has been discussed in a number of cases in recent years: e.g. see *Daihatsu Australia Pty. Limited v. FC of T* 2001 ATC 4268, [2001] FCA 588; *WR Carpenter Holdings Pty. Ltd. & anor v. FC of* T 2007 ATC 4679, 66 ATR 336, [2007] FCAFC 103; and *Roche Products Pty. Ltd. v. FC of T* 2008 ATC 10-036, 70 ATR 703, [2008] AATA 639. In *Daihatsu Australia Pty. Limited v. FC of T* 2001 ATC 4268; [2001] FCA 588; Finn J noted that:

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	is to situations where it is not practicable or possible to determine the arm's length consideration. We reject the notion that it is not possible to price debt that is considered by the ATO to be non-arm's length. In relation to financing transactions where market data is readily available and the behaviour of credit rating agencies is reasonably transparent in determining creditworthiness, the ATO is not able to resort to section 136AD(4) as the conditions in order to apply that section are not met. We therefore disagree that the ATO should need to resort to section 136AD(4) to reprice debt related transactions.	60. …The sufficiency of the information available to the Commissioner to make it practicable and possible to ascertain an 'arm's length consideration' (s 136AD(3) and (4)) would seem, prima facie, to be a matter for the judgment of the Commissioner. In *WR Carpenter Holdings Pty. Ltd. & anor v. FC of T* 2007 ATC 4679; 66 ATR 336; [2007] FCAFC 103; Heerey, Stone and Edmonds JJ in a similar vein explained that: 32. Once it is seen that subs (4) is there for the exceptional case, its function in the Div 13 machinery becomes apparent. It operates like an averment clause. It does not create an irrebuttable presumption. It simply provides the Commissioner with a means of proof. … It is difficult to see how the possibility or practicability of ascertainment that faced the Commissioner at the time of assessment would be relevant to the applicants' argument, before the Court, that the figure advanced by them is in fact the correct arm's length consideration. 33. If, after evidence and argument, the applicants fail to show that the figure advanced by them is, on the balance of probabilities, the correct arm's length consideration, then the assessments will be affirmed. It could hardly matter that at the time of the assessment it might have been practicable or possible for the Commissioner to ascertain an arm's length consideration. Logically, what tax liability must turn on is whether the applicants have managed to displace the Commissioner's deemed figure. 37. … in order to show that an assessment made in reliance on determinations made under para (d) of subs 136AD(1) or (2) and subs 136AD(4) is excessive, it would be necessary for the applicants to show that the arm's length consideration is both ascertainable and less than the deemed amount; that, in itself, would seem to require the applicants to prove the actual amount of the arm's length consideration. In the course of doing so they would necessarily establish that the arm's length consideration was ascertainable. In *Roche Products Pty. Ltd. v. FC of T* 2008 ATC 10-036; 70 ATR 703; [2008] AATA 639; Downes J stated: 192. As I read s 136AD(4) it empowers the Commissioner to issue an assessment notwithstanding that there is not sufficient evidence which would ordinarily enable him to do so. I do not see why, on review, the Tribunal does not have the same power. The power is to use material which might otherwise be less than persuasive, or to reason from information in circumstances where reasoning might not otherwise be fully justified. Nevertheless, the process needs

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		to be a rational one. The discretion needs to be exercised in accordance with reason.
11	***All debt arrangements can be priced*** An arm's length price can in fact be determined for debt funding arrangements in place, whether they are funding arrangements which would exist between independent parties dealing at arm's length or not. The price would simply be a reflection of the increased leverage and increased risk of default. Lenders may extend credit to an enterprise with ongoing losses and investors may borrow, even if the borrowing results in losses. This statement (and similar assertions throughout the revised draft ruling) again raises the question of how the ATO might treat debt amounts that it regards to be beyond an arm's-length debt amount for transfer pricing purposes (but within the thin capitalisation safe harbour). The explanation appears to impose a requirement for 'real bargaining' between related parties in order to justify a related-party financing transaction – and presumably this applies (in the ATO's view) to both the pricing of the subsidiary's debt and its capital structure. It should be noted that market benchmarks are the result of real bargaining; hence, if a price is arm's-length under Division 13, some artificial process of internal negotiation should not be required for Australian taxation purposes to justify a taxpayer's intra-group transactions. The ATO should consider clarifying the requirement of what would occur between independent entities to consider what an independent lender would loan to the entity having regard to more objective measures such as the credit rating of the entity rather than requiring a benchmarking analysis of what other comparable companies have borrowed. Junk bonds are a fact of commercial life – both at a corporate and commercial level. The key issue is whether a certain loan amount can be priced.	We do not accept that an arm's length price can be determined simply on the basis of the 'reflection of the increased leverage and increased risk of default'. A market price may be determined on such a basis. However the market price determined does not necessarily equate to an arm's length price. An arm's length interest rate is not determined solely by referring to a market index or price (see paragraphs 2.25-2.27 of Taxation Ruling TR 97/20). Further, we do not accept that, in pricing debt, there is *always* 'clearly sufficient information to establish the arm's length price without the Commissioner having to resort to subsection 136AD(4)'. As indicated at paragraphs 48, 50, 60 and 78 of the final Ruling, the ATO has a number of concerns from a transfer pricing perspective with a market pricing method that relies *only* on the stand-alone credit rating of a subsidiary having a controlled balance sheet (that is, where the parent has the ability to determine both the strength of the balance sheet and the terms and conditions of the associated enterprises loan). To show that the market price gives an arm's length price for the interest rate charged on an associated enterprises loan, one needs to be able to demonstrate that independent parties in an arm's length transaction would have entered into the same arrangement. Hence, the willingness of arm's length lenders to provide that amount of debt funding to a controlled subsidiary having a particular risk structure and characteristics, is a factor that should be considered when using a market price. Likewise, whether an arm's length borrower might be expected to take out that loan, given the high level of debt and associated financing costs. The arm's length principle requires consideration of whether an associated enterprises loan would have been made at all, or made on those terms, if the transaction was between arm's length entities. Before any comparables could be considered to be arm's length benchmarks for the pricing of an associated enterprise loan, it would be fundamental to consider whether the outcome obtained by using such comparables would make 'commercial sense' in the circumstances of the case. This enables a conclusion to be made as to whether independent parties dealing at arm's length would be expected to lend and to borrow at that price in comparable circumstances. The 'commercial sense' principle is explained in Taxation Ruling TR 97/20.

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	We would submit that most loan amounts can be priced at a rate which independent parties would agree to and that to substitute an 'arm's length amount of debt' for the actual amount of debt oversteps the scope and application of Division 13.	2.4. Implicit in the arm's length principle is the notion that independent parties who are dealing at arm's length would each compare the options realistically available to them, and seek to maximise the overall value of their respective entities from the economic resources available to or obtainable by them (1995 OECD Report, paragraph 1.16; TR 94/14, paragraph 66). … 2.15. …To be a reliable benchmark for dealings with associated enterprises, transactions or arrangements with independent parties also have to be undertaken in comparable circumstances. They also have to make business sense in all the taxpayer's circumstances (including its gearing and financial position – **paragraph 3.27** and paragraph 1.37 of the 1995 OECD Report – its cost structure, business strategies and the then prevailing market and economic conditions), having regard to what the taxpayer obtained in return for the functions it performed, the assets it used, and the risks it assumed. 2.17. … One option, however, might be not to enter into a transaction because it does not make commercial sense for the particular taxpayer. 2.27. Comparability is the key issue in the application of most arm's length methods. This remains true with use of public indices. … It may not always be appropriate to rely on a market index in the particular circumstances of an enterprise. The use of data from market indices should have regard to the need for the analysis to produce outcomes that make business sense (**paragraphs 1.1, 2.16, 2.17, 3.2 and 3.3**). 3.2. … When dealing at arm's length, the parties generally have the option not to proceed with the dealings if the market prices do not satisfy their profit expectations or business strategies. 3.3. For example, if the prevailing market prices lead to unsatisfactory profit levels, then dealings may ultimately not be concluded or may be conducted in a different manner or on different terms. This indicates that arm's length dealings involve both the establishment of the market terms and conditions and an assessment of the implication of these dealings for the profits of the enterprise. It may not make commercial sense if financing expenses from an associated enterprise loan were so significant that operating with these costs was not commercially viable or did not leave a commercially realistic return for the functions

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		performed, assets used and risks assumed in the relevant business activities. There will typically be cases where the debt arrangements in question do not make commercial sense and so similar arrangements cannot be found as comparables. Here the application of subsection 136AD(4) could be a possibility.
12	***Use of benchmark interest rates*** The ATO seem to be suggesting that interest rates will never be challenged provided the rates are no more than short cuts (viz LIBOR/SIBOR/BBSR, the ROT rate, OECD prime and bank rates or the 'on-lending' rate). Any taxpayer that does not accept the ATO's non-arm's length short-cuts will have to undertake the arm's length debt amount analysis. The Ruling requires all taxpayers not prepared to accept the short-cuts to determine a 'commercially realistic rate of return' using, for example, a TNMM. Concerned with TNMM or other profits based approaches, as there are many reasons for which a taxpayer may have accounting losses.	Refer to paragraphs 47 and 48 of the final Ruling. Taxation Ruling TR 92/11 at paragraph 80(c) contemplates the use of internationally recognised benchmark rates, such as LIBOR and SIBOR, as they are generally indicative of the basic interest rates for transactions in those currencies. It is not correct that any taxpayer not using the LIBOR/SIBOR /BBSR interest rates will have to undertake an arm's length debt amount analysis. It is equally incorrect that the Ruling requires all taxpayers not prepared to accept these rates to determine a commercially realistic rate of return using the Transactional Net Margin Method. However, we do consider it is necessary for a taxpayer's associated enterprise debt arrangements to reflect a commercially realistic outcome. Note that paragraph 50 of the final Ruling states: In using any data as to uncontrolled comparables or open market prices in determining the arm's length consideration for an associated enterprise loan, it is necessary to take account of whether the outcome makes commercial sense in all of the circumstances of the case. This enables a conclusion to be made as to whether independent parties dealing at arm's length would be prepared to lend and to borrow in comparable circumstances and, if so, whether they would agree to a loan at that price. Paragraph 60 of the final Ruling adds: Consistent with the Commissioner's views set out in TR 97/20, and as explained above, the arm's length principle requires that the pricing of a taxpayer's associated enterprise dealings should make commercial sense in all of the circumstances of the case (including the taxpayer's gearing and financial position, cost structure, business strategies and prevailing market and economic conditions). We accept that caution is required with the use of TNMM or other profits based methods, as there may be a number of reasons why a taxpayer is making losses.