TR 2002/2 - Income tax: meaning of "Arm's Length" for the purpose of subsection 47A(7) of the Income Tax Assessment Act 1936 (ITAA 1936) dividend deeming provisions

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Taxation Ruling

Income tax: meaning of "Arm's Length" for the purpose of subsection 47A(7) of the *Income Tax Assessment Act 1936* (ITAA 1936) dividend deeming provisions

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Preamble

The number, subject heading, ***Class of person/arrangement, Date of effect*** *and* ***Ruling*** *parts of this document are a 'public ruling' for the purposes of Part IVAAA of the* ***Taxation Administration Act 1953*** *and are legally binding on the Commissioner. The remainder of the document is administratively binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

Class of persons/arrangements

1. This ruling applies to you if you are an 'entity' (generally, a company) that is a shareholder in a controlled foreign corporation (CFC) that is a resident of an unlisted country and you or an associate receives a 'distribution benefit' from the making of a loan by, or sourced from, the CFC.

What this ruling is about

2. This ruling explains the meaning of the arm's length test contained in paragraph 47A(7)(a) of the ITAA 1936.

Ruling

3. The arm's length test in paragraph 47A(7)(a) is to be taken as referring to the nature of the dealing rather than the relationship that exists between the parties to the loan. (See paragraphs 16 to 22).

4. Whether a loan satisfies the arm's length test will ultimately be determined by reference to the facts of each particular case and the outcome that might have been expected to arise between independent parties in comparable circumstances. (See paragraphs 23 to 24).

5. The principles in other provisions in the ITAA 1936 which rely on the arm's length test are relevant. (See paragraph 26).

6. Even if the interest rate applicable to the loan is an arm's length interest rate, it is still necessary to determine whether independent parties would have entered into the loan at all. (See paragraph 19).

7. Section 47A is a self executing provision. When it applies, it does not deal with just the difference between the interest rate charged and the arm's length interest rate but treats the whole amount of the loan (or, in indirect cases, the amount attributable to the provision of a loan) as a deemed dividend. (See paragraph 27).

Date of effect

8. This Ruling applies to income years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Purpose of section 47A

9. Section 47A forms part of the accruals regime (predominantly contained in Part X of the ITAA 1936) and operates as an anti-avoidance provision.

10. The intent of section 47A is to prevent the avoidance of the accruals regime (and tax) by the shifting of profits from unlisted countries to Australia or to listed countries as disguised dividends ('eligible benefits'). The transfer may be made direct to the taxpayer or indirectly to the taxpayer or an associated entity through an 'arranger'.

11. The types of transactions that are intended to be caught by the legislation are covered by specific subsections within section 47A. Subsection 47A(7) deals with loans.

12. Where section 47A applies, the relevant amount is, subject to conditions, deemed to be a dividend. However, the deemed dividend cannot exceed the amount of profits held by the relevant CFC in an unlisted country. The deemed dividend is treated as a dividend for all purposes of the ITAA 1936.

Section 47A(7) and loans between related entities

13. Subsection 47A(7) sets out the circumstances in which a 'loan' (a defined term) between related entities is to be treated as an eligible benefit.

14. For subsection 47A(7) to apply, one of 3 conditions must be satisfied, namely:

(a) The parties to the loan are not at arm's length with each other in relation to the loan (paragraph 47A(7)(a));

(b) The purpose, or one of the purposes of the loan, was to facilitate the payment of an exempt dividend (paragraph 47A(7)(b)); or

(c) The purpose of the loan was to facilitate the making of an eligible benefit (paragraph 47A(7)(c)).

15. Paragraph 47A(7)(a) does not specifically refer to the purpose of the loan. However, because of the nature of the test, purpose is one factor to be taken into account in determining the nature of the dealing, ie, in determining whether or not the loan is of an arm's length nature and one that independent parties would enter into.

Meaning of 'arm's length' in subsection 47A(7)

16. The term 'arm's length' is used in both tax and non-tax legislation. However, variations exist in the way in which the term is used and judicial interpretations have varied accordingly. The case *Pontifex Jewellers(Wholesale) Pty Ltd v FCT* [1999] FCA 1822, 43 ATR 643 contains a useful summary of case law on the different meanings of the term 'arm's length'. Comments that follow are drawn from that summary.

17. The case law draws a distinction between two uses of the term 'arm's length'. One refers to **the relationship of the parties to a transaction** (i.e., whether the parties are related in some way) and the other refers to the **terms of a transaction** between the parties (i.e., whether they are those that could be expected to arise between independent parties).

18. The relevant judicial decisions turn on both the language used and the context in which the term 'arm's length' appears. When a statute refers to parties dealing at arm's length, or to a specific transaction being at arm's length, the arm's length test is generally taken to refer to the terms of the transactions such as would be entered into between independent parties.

19. The context of subsection 47A(7) and the language of paragraph 47A(7)(a) support the latter approach. The purpose of this subsection is to identify the transfer of a benefit which, in essence, is a

disguised transfer of profits. Paragraphs (a), (b) and (c) of that subsection are intended to each identify a separate transaction which may result in a deemed dividend. The nature of the language and purpose of the provisions lead to the conclusion that paragraph (a) is intended to apply to a situation which involves the transfer of an amount. This arises if the terms of the relevant loan are not comparable to those that would be entered into between independent parties or if the circumstances are such that independent parties would not have entered into the loan at all.

20. This conclusion can also be arrived at by considering the alternative meaning of 'arm's length' in paragraph 47A(7)(a), i.e., that it is intended to refer to the relationship of the parties. If this premise is correct, all loans between parties that are not independent of each other would come within the scope of the paragraph. As a result, the sum of all loans made in a financial year between, say, a corporate treasury that is a CFC in an unlisted country and Australian attributable taxpayer shareholders would be deemed dividends even though the loans may have been made on terms and conditions which were comparable to those that would be entered into by independent parties. Clearly, this would be an absurd result as it would severely impact on the commercial operations of corporate groups.

21. Furthermore, if it is necessary to consult extrinsic material, the commentary (see paragraph 24 below) in the Explanatory Memorandum relating to the Taxation Laws Amendment (Foreign Income) Act 1990, focuses on factors relevant to the loan rather than to the relationship of the parties.

22. Paragraph 47A(7)(a) is, accordingly, to be interpreted as referring to the nature and terms of the loan in question, and not to the fact that the parties to the loan are in some way related to each other.

Criteria for determining whether a loan is 'arm's length'

23. Section 47A is silent as to the criteria for determining if parties are at arm's length in relation to a loan for the purposes of paragraph 47A(7)(a). Whether parties are at arm's length in relation to a loan is a question of fact.

24. The Explanatory Memorandum relating to *the Taxation Laws Amendment (Foreign Income) Act 1990*, in referring to section 47A states:

> 'Whether the parties to a loan are at arm's length in relation to the loan is to be determined having regard to factors such as the amount of the loan, the rate of interest payable, the security for the loan, and the capacity of the borrower to repay the loan. A loan will be an arm's length loan where, having regard to these factors, the terms and conditions of the loan are those

that would have been agreed between independent third parties acting at arm's length.'

25. By necessity, the arm's length test must be considered from the perspective of both provider/lender and recipient/borrower. It considers what independent parties acting in their own commercial interests in situations comparable to those of the relevant parties to the loan would have negotiated. It is an objective test that takes into account whether the loan is commercially realistic.

26. In applying the arm's length test, reference may be made to the principles in other provisions in the ITAA 1936 which rely on an arm's length test.

27. Section 47A is a self executing and separate provision. When it applies, it does not deal with just the difference between the price charged and the arm's length price, but treats the whole amount of the loan as a deemed dividend. This consequence of section 47A applying needs to be kept in mind so that the administration of the section does not interfere with normal commercial corporate operations.

28. The loan in question should, therefore, be considered against the background of the general practices and operations of the corporate group and should not be considered in isolation. Being mindful of the differences in the operation of related and unrelated company dealings, the existence of the loan and its terms would need to be compared to a similar dealing between independent parties. Some form of comparability would need to be established.

29. For the purpose of paragraph 47A(7)(a), one of the factors to be considered in applying the arm's length test to a loan is whether it is at a commercial rate of interest. Accordingly, an interest rate would need to be set at a value that accurately reflects all relevant factors. The use of a standard market benchmark rate does not necessarily satisfy the arm's length test.

30. By its nature, a commercial rate of interest is peculiar to the case and situation of the parties. Any quoted or market benchmark interest rates, e.g., LIBOR, SIBOR and the Australian Bank Bill Rate, reflect certain market assumptions. However, in the negotiation of an actual loan, including the interest rate, these market rates are normally adjusted to reflect all the risks and circumstances of the borrower and the lender. Thus, the international benchmark rates are not necessarily commercial or arm's length rates in differing circumstances.

31. The interest rate applied to a loan between related parties should be indicative of parties acting at arm's length and reflect the commercial and economic standing of the parties.

32. Accordingly, an interest rate would need to be set at a value that would accurately reflect **all relevant factors**. These include, the

purpose behind the loan, the amount, the terms and conditions, the duration of the loan, the security offered, the ability to repay, the credit standing of the borrower and the prevailing market conditions at the time.

Detailed contents list

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Commissioner of Taxation
30 January 2002

Previous draft:

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Related Rulings/Determinations:

TR 92/20

Subject references:

- controlled foreign companies
- deemed dividends
- deemed dividends of CFCs

Legislative references:

- ITAA 1936 47A
- ITAA 1936 47A(7)
- ITAA 1936 47A(7)(a)
- ITAA 1936 47A(7)(b)
- ITAA 1936 47A(7)(c)
- ITAA 1936 Part X
- TLA(FI) 1990

Case references:

- Pontifex Jewellers (Wholesale) Pty Ltd v. FCT [1999] FCA 1822; 43 ATR 643

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