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 cover sheet is provided for information only. It does not form part of *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 document has been finalised by TR 2010/7.

There is a Compendium for this document: **TR 2010/7EC** .

You can also access the opinion and supplementary opinion obtained as part of the process of assisting the Commissioner to formulate the views expressed in this draft Ruling. These opinions are general in nature, do not provide advice or a Tax Office view on the application of any aspect of the law and cannot be relied upon for any purpose. These opinions are being published for the purposes of transparency only. Taxpayers may approach the Tax Office if they would like a Tax Office view on how the law applies to their particular circumstances.

Draft Taxation Ruling

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

Contents Para

PROPOSED LEGALLY BINDING SECTION:

What this Ruling is about 1

Previous Draft Determination 3

Ruling 4

Date of effect 17

NOT LEGALLY BINDING SECTION:

Appendix 1:

Explanation 19

Appendix 2:

Alternative views 50

Appendix 3:

Your comments 52

Appendix 4:

Detailed contents list 54

This publication provides you with the following level of protection:

This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the following way. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

What this Ruling is about

1. This draft Ruling explains the Commissioner's view of how the thin capitalisation provisions in Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997) interact with the transfer pricing provisions. All references in this draft Ruling to Division 820 and its provisions are references to Division 820 of the ITAA 1997.

2. A reference in this draft Ruling to 'transfer pricing provisions' is a reference to Division 13 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936)[1] and the relevant provisions of Australia's tax treaties.[2]

[1] All references to Division 13 are references to Division 13 of Part III of the ITAA 1936.

[2] Provisions of Australia's tax treaties, notably the Business Profits Article and the Associated Enterprises Article, contemplate adjustments to profits to reflect the outcome that would be achieved if cross-border dealings had been conducted in accordance with the internationally accepted arm's length principle.

Previous Draft Determination

3. Draft Taxation Determination TD 2007/D20 is withdrawn with effect from today.

Ruling

4. Where an entity does not have excess debt,[3] such that the thin capitalisation provisions under Division 820 do not result in a disallowance of any portion of the amounts comprising the entity's 'debt deduction',[4] the transfer pricing provisions can still be applied to adjust the pricing of associated costs. Such costs include interest expenses, discounts on commercial paper or other costs that are directly incurred in obtaining or maintaining the debt funding.

5. However, the transfer pricing provisions in Division 13 cannot be applied to completely deny deductions for funding costs on debt that is not excess debt for the purposes of Division 820 merely because those deductions relate to a portion of the total debt funding that might be considered excessive when compared to the levels of debt and equity that would be required for the entity to be regarded as an independent entity dealing wholly independently in respect of its debt funding arrangements. To do that would 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'[5] even though the safe harbour amount in the particular case is greater than the arm's length amount of debt determined by applying the arm's length principle in the transfer pricing provisions.[6]

[3] 'Excess debt' as used in this draft Ruling is a reference to debt to the extent it exceeds an entity's 'maximum allowable debt' under Division 820 of the ITAA 1997 as defined in section 995-1 of that Act.
[4] 'Debt deduction' is defined in section 820-40 of Division 820.
[5] See sections 820-90, 820-190, 820-305 and 820-400. In the case of 'approved deposit-taking institutions', Division 820 safe harbours are based on a level of capital less than the arm's length capital amount producing a similar effect to a debt level in excess of the arm's length debt amount.
[6] Contrast the 'arm's length debt amount' test in section 820-215. An arm's length debt amount determined under arm's length principles might not be the same as the 'arm's length debt amount' determined under section 820-215.

6. The existence of a 'safe harbour debt amount'[7] for the purposes of Division 820 does not prevent the Commissioner from determining an appropriate arm's length cost for all of the debt funding. It is clear from the wording of paragraph 820-40(1)(b) that the operation of Division 820 is limited to borrowing costs that the entity can deduct from its assessable income. Accordingly, all provisions relevant to deductibility must be applied first before Division 820 comes into operation. The purpose of Division 820 is to set an upper limit on the amount of debt an entity can have and, where the debt level exceeds the statutory limit, to disallow a proportion of the debt deduction based on the ratio of the excessive debt amount to the average debt for the year of income. It follows that the application of the arm's length principle in the transfer pricing provisions is in accordance with the provisions of section 820-40 and does not conflict with the purpose of Division 820.

7. Any arm's length interest rate worked out under the transfer pricing provisions would be applied to the actual amount of debt.[8]

8. The following examples are intended to illustrate the respective fields of operation of the transfer pricing provisions in Division 13 and the thin capitalisation rules in Division 820.

Example 1 – transfer pricing provisions do not defeat the operation of the thin capitalisation provisions

9. *Aus Co is an Australian resident subsidiary company of For Co, the parent company that is resident in a country with which Australia has a tax treaty. Being an industrial company and not an ADI,*[9] *Aus Co is an 'inward investment vehicle (general)' for the purposes of Subdivision 820-C.*

10. *For an income year, Aus Co has:*

- *a 'safe harbour debt amount', determined in accordance with section 820-195, of $375m;*
- *'adjusted average debt', determined in accordance with subsection 820-185(3),*[10] *of $400m borrowed from For Co at an interest rate of 10%; and*
- *equity of $100m.*

11. *Aus Co's only debt deductions are for the interest incurred at a rate of 10% on its $400m debt, meaning that it has $40m of debt deductions for the income year.*

---

[7] See the definition of that term in section 995-1 of the ITAA 1997.
[8] So as not to defeat the operation of Division 820; refer to paragraph 46 of this draft Ruling.
[9] Authorised Deposit taking Institution – within the meaning of section 995-1 of the ITAA 1997.
[10] For the purposes of the example 'adjusted average debt' is the same amount as the average debt.

12. *Assume that, applying the arm's length principle embodied in Division 13 and the relevant Associated Enterprises Article, an arm's length amount of debt for Aus Co would be $334m, which could be borrowed at an interest rate of 10% if Aus Co was dealing independently. On that basis, Aus Co might be considered to have excessive debt of $66m. However, for the purposes of Division 820, Aus Co has excess debt of only $25m because of the operation of the safe harbour debt amount rules.*

13. *Section 820-220 operates to deny $2.5m of Aus Co's $40m debt deductions because, by reference to the statutory safe harbour, it has excess debt of $25m, which is 6.25% of its 'adjusted average debt' for the particular year of income. 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.*

Example 2 – transfer pricing provisions can adjust the pricing of debt costs notwithstanding there is no excess debt under the thin capitalisation provisions

14. *Assume instead that Aus Co has $300m of 'adjusted average debt'*[11] *and $100m of equity, producing a safe harbour debt amount of $300m. The interest rate on Aus Co's debt to For Co is 20%, so that, before applying the transfer pricing provisions and Division 820, Aus Co has debt deductions of $60m.*

15. *The transfer pricing provisions in Division 13 and the relevant Associated Enterprises Article would be applied to reduce Aus Co's debt deductions to an amount based on the interest rate that Aus Co could have obtained on the open market if it were dealing independently, which is 10% (assuming that Aus Co was able to borrow the whole $300m)*.[12] *This results in a reduction in the interest deduction from $60m to $30m. Accordingly this adjustment to interest deductions reduces the debt deduction for the purposes of Division 820*[13] *to $30m.*

16. *Section 820-220 would not operate to deny any of that $30m because Aus Co does not exceed the safe harbour debt amount.*

[11] For the purposes of the example 'adjusted average debt' is the same amount as the average debt.
[12] Paragraphs 28 to 36 of this draft Ruling provide guidance on how arm's length consideration can be established in the context of a loan.
[13] See section 820-40.

Date of effect

17. When the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 77 of Taxation Ruling TR 2006/10).

18. The Tax Office has also issued a draft Law Administration Practice Statement PS LA 3187 (draft) as an interim measure which provides a practical 'rule of thumb' approach for the transfer pricing of interest payable by a taxpayer on a cross-border related party loan.

Commissioner of Taxation
16 December 2009

Appendix 1 – Explanation

❗ ***This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.***

Transfer pricing provisions

19. The transfer pricing provisions and the thin capitalisation rules have different functions. The function of the transfer pricing provisions is to ensure Australia can counter 'non-arm's length transfer pricing' or 'international profit shifting' arrangements in order to protect the Australian tax base.[14] They provide a mechanism by which Australia adopts the internationally accepted 'arm's length principle' for taxation purposes as the basis for ensuring that Australia receives its fair share of tax by adjusting profits by reference to the conditions which would have existed between independent parties under comparable circumstances.[15]

Division 13

20. Section 136AD of Division 13 is concerned with the consideration for a supply or acquisition of property under an international agreement.[16] Section 136AD of Division 13 empowers the Commissioner, where various conditions are met, to make a determination having the effect that an arm's length consideration is deemed to apply in respect of the property[17] supplied or acquired. Such a determination can result in adjustments to increase assessable income or to disallow or reduce an allowable deduction. The arm's length consideration replaces the actual consideration for all purposes of the application of the Act,[18] see paragraphs 179 to 181 of Taxation Ruling TR 94/14 and paragraphs 2 to 4 of Taxation Ruling TR 2007/1.

21. This results in not only the underlying consideration in respect of the supply or acquisition of property being adjusted to the arm's length consideration, but also has flow-on consequences for the taxpayer where that consideration is relevant to the operation of other provisions of the Act. Subsection 136AB(1) of Division 13 provides that 'nothing in the provisions of this Act (including Division 820 of the ITAA 1997) other than this Division shall be taken to limit the operation of this Division'.

---

[14] The relevant treaty articles also operate to allocate taxing rights between countries.
[15] Refer paragraph 10 of Taxation Ruling TR 94/14.
[16] 'International agreement' is defined in section 136AC of Division 13.
[17] Property includes services for this purpose – see the definition of 'property' in subsection 136AA(1) of the ITAA 1936.
[18] Refer to subsections 136AD(1), (2) or (3) of the ITAA 1936.

22. As noted in Taxation Ruling TR 92/11,[19] Division 13 may be applied to determine the deemed arm's length consideration for an actual loan entered into by an entity. Where (for example) a foreign parent lends money to an Australian subsidiary, the Australian subsidiary acquires property under an 'international agreement' for the purposes of Division 13. Subsection 136AD(3) of Division 13 is the operative provision in the case of an acquisition of property under an 'international agreement'.

23. Under subsection 136AD(3) of Division 13, the deduction for actual interest expense claimed by a resident company on a loan received by it from a non-resident company may be reduced if the interest expense on that loan is more than an arm's length amount.[20] The task required by paragraph 136AD(3)(c) of Division 13 is to determine whether the actual interest expense exceeded the amount of interest that would have been given or agreed to be given if the loan had been acquired under an agreement between independent parties dealing at arm's length with each other in relation to the acquisition.

Tax treaties

24. Provisions of Australia's tax treaties, notably the Business Profits Article and the Associated Enterprises Article,[21] contemplate adjustments to profits[22] to reflect the outcome that would be achieved if cross-border dealings had been conducted in accordance with the internationally accepted arm's length principle. Australia's tax treaties are included as schedules to the *International Tax Agreements Act 1953* (the Agreements Act).

---

[19] Taxation Ruling TR 92/11 discusses the supply and acquisition of property under an 'international agreement' in relation to loans and credit balances.
[20] Refer paragraph 7(b) of Taxation Ruling TR 92/11.
[21] For example, Articles 7 and 9 of the USA Convention in Schedule 2 of the *International Tax Agreements Act 1953* (Agreements Act).
[22] Subsection 3(2) of the Agreements Act provides that for the purposes of that Act and the ITAA 1936 a reference to profits of an activity or a business shall, in relation to Australian tax, be read, where the context so permits, as a reference to taxable income derived from that activity or business.

25. The Commissioner has long considered 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 those related treaty provisions.[23] This view has been questioned following the recent decision *In Re Roche Products Pty Ltd and the Federal Commissioner of Taxation*.[24] In that matter, Downes J stated:

> 189. Submissions were put to me on two particular matters I have not dealt with so far. The first was whether the double tax treaties as incorporated into Australian law conferred a power to assess...
>
> 190. So far as the first is concerned I note that the submissions were limited (particularly those of the Commissioner) and both parties accepted that the result in this case would not be affected if the treaties conferred no power to assess. This is because the issues in this case concerned pricing and, to the extent that the double tax treaties relate to profits, the only ultimate relevance of profit was that it reflected prices. Notwithstanding the different tests of independent pricing and arm's length dealing it was accepted that these are essentially the same tests, a proposition which is supported by the OECD Guidelines.
>
> 191. In the result I do not need to decide the issue although I note that there is a lot to be said for the proposition that the treaties, even as enacted as part of the law of Australia, do not go past authorising legislation and do not confer power on the Commissioner to assess. They allocate taxing power between the treaty parties rather than conferring any power to assess on the assessing body. On this basis Division 13 should be seen as the relevant legislative enactment pursuant to the power allocated.

[23] Note Taxation Ruling IT 2311, paragraph 18 of Taxation Ruling IT 2670, paragraph 62 of Taxation Ruling TR 92/11, paragraphs 18, 184–186 of Taxation Ruling TR 94/14, paragraph 35 of Taxation Ruling TR 95/23, paragraphs 1.10–1.11 of Taxation Ruling TR 97/20, paragraphs 1, 14-15, 29 of Taxation Ruling TR 1999/1, paragraphs 2.13–2.14 of Taxation Ruling TR 2001/11, paragraphs 32-33 of Taxation Ruling TR 2001/13; Taxation Determination TD 2002/20 and paragraph 26 of Taxation Ruling TR 2007/1.

[24] [2008] AATA 639; 2008 ATC 10-036; (2008) 70 ATR 703 (*Roche*). Other cases have touched on the general issue of the status of the treaties, though none dealt with transfer pricing issues: see *McDermott Industries (Aust) Pty Ltd v. Commissioner of Taxation* (2005) 142 FCR 134 at [2]; *Commissioner of Taxation v. Lamesa Holdings BV* (1997) 77 FCR 597 at 600-1; *Chong v. Commissioner of Taxation* (2000) 101 FCR 134 (*Chong*) at [26]; *GE Capital Finance Pty Ltd v. Federal Commissioner of Taxation* (2007) 159 FCR 473 at [36], [37] and *Undershaft (No 1) Limited v. Commissioner of Taxation* [2009] FCA 41 (*Undershaft*) at [45], [46]. In *Undershaft*, Lindgren J cited, inter alia, *Chong* and reiterated that the tax treaty does not give the contracting State a power to tax, or oblige it to tax but, rather, avoids the potential for double taxation by restricting one contracting State's taxing power.

26. Amendments made at the time of the introduction of Division 13 in 1982[25] appeared to signal an intention on the part of the Parliament that amended assessments could be made to give effect to 'a provision of a double taxation agreement that attributes to a permanent establishment or to an enterprise the profits it might be expected to derive if it were independent and dealing at arm's length' (see subsection 170(9B) of the ITAA 1936 and the definition of 'relevant provision' in subsection 170(14) of the ITAA 1936).

27. However, as discussed at paragraph 186 of Taxation Ruling TR 94/14, there should be no fundamental inconsistency between the results under Division 13 and the relevant treaty provisions in relation to dealings between associated enterprises, since both are based on the arm's length principle. (The comments of Downes J at paragraph 190 of *Roche* seem consistent with that general proposition.) So, for example, it is the Commissioner's view that both Division 13 and the Associated Enterprises Article allow for the use of indirect methods for determining arm's length consideration (see paragraphs 1.15 to 1.24 of Taxation Ruling TR 97/20) where direct methods are either not practicable or not reliable. Therefore, the issue of whether there is a power to assess to give effect to the treaty provisions is likely to be of practical significance only if the Commissioner's view that Division 13 is as extensive as the treaty provisions in this respect is found to be wrong by the Courts.

Working out arm's length consideration in relation to debt funding

28. The Commissioner has provided extensive guidance on how to work out an arm's length consideration under the transfer pricing provisions (see in particular Taxation Rulings TR 92/11, TR 94/14 and TR 97/20). The transfer pricing provisions incorporate the internationally accepted arm's length principle to determine the arm's length consideration. The arm's length principle involves comparing what a business has done and what a truly independent party would have done in the same or similar circumstances. Accordingly, the arm's length consideration should be consistent with the consideration that would arise as a result of real bargaining between independent parties and should reflect commercial and market realities. Taxation Rulings TR 94/14 and TR 98/11 provide details of the information and evidence (including the standard of documentation) that is required for a taxpayer to substantiate that the consideration in relation to any particular arrangement is an arm's length consideration.[26]

[25] See subsections 170(9B) and 170(9C) of the ITAA 1936 and the now replaced subsections 225(2) and 226(2B) to 226(2F) of the ITAA 1936.
[26] In relation to Taxation Ruling TR 94/14, see paragraphs 101 to 113 and 368 to 389.

29. Relevant facts and circumstances to be taken into account in determining the arm's length consideration in relation to a loan include (per paragraph 83 of Taxation Ruling TR 92/11):

(a) the nature and purpose of the loan;

(b) the market conditions at the time the loan was granted;

(c) the amount, duration and terms of the loan;

(d) currency in which the loan is provided and the currency in which repayment has to be made;

(e) security offered by the borrower;

(f) guarantees involved in the loan;

(g) the credit standing of the borrower;

(h) situs of lender and borrower; and

(i) the prevailing interest rates for comparable loans.

30. The capacity of an entity to obtain debt funding (and any associated guarantees) in arm's length dealings is significantly affected by its credit standing (creditworthiness), since both a lender and a guarantor of loans will have regard to:

- the probability that the borrower will default;
- the exposure of the lender or the guarantor in the event of default; and
- the loss given default.

31. Paragraph 136AA(3)(c) of the ITAA 1936 defines the arm's length consideration in respect of the acquisition of the property as the consideration that might be expected to have been given or agreed to be given if the property had been acquired under an agreement between independent parties dealing at arm's length with each other in relation to the acquisition. Importantly the definition depends on the capacity to deal not just in terms of authority (which can be hypothesised) but also in a practical sense in that the dealing is one that would occur between independent parties.

32. There are long established models for determining creditworthiness which have common characteristics based on a mix of qualitative and quantitative factors. These factors include the capital structure of the borrower, asset levels, realisable value of assets, strength of cashflow, capacity to absorb losses, probability of default and extent of recourse (including the possibility of wider recourse, additional financial support and parental affiliation). 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.

33. As indicated above, Division 13 is not a stand alone provision but operates in conjunction with other provisions of the income tax legislation. Where all of paragraphs (a), (b), (c) and (d) of subsection 136AD(3) have been satisfied and an arm's length consideration determined in relation to the loan, the actual interest expense incurred is deemed to be adjusted to the arm's length amount (consideration) for all income tax purposes.

34. Where it is not possible or practicable for the Commissioner to ascertain the arm's length consideration, subsection 136AD(4) enables the Commissioner to determine on a reasonable basis an amount as the arm's length consideration consistent with an amount that would have been provided between independent parties dealing at arm's length with each other in relation to the acquisition.

35. Subsection 136AD(4) is silent as to the manner in which the relevant 'amount' is to be determined. However, the determination of the relevant 'amount' (which is then deemed to be the arm's length consideration) needs to be approached in a manner which, in all the circumstances of the case, would lead to a fair result that is as consistent as practicable with the arm's length principle as internationally accepted.[27]

36. If the available information and evidence enables an arm's length consideration to be ascertained by applying an accepted pricing methodology appropriate to, and reliable in, the particular case (see Taxation Rulings TR 92/11, TR 94/14 and TR 97/20), then that consideration can be used as the arm's length consideration for the purposes of the transfer pricing provisions. However, there may be circumstances where the information and evidence used by a taxpayer is not sufficient to justify the approach they have adopted. In those circumstances, the Commissioner may need to undertake his own analysis to determine an arm's length consideration in a manner as consistent as practicable with the arm's length principle and in accordance with the taxation rulings mentioned above. In cases where no readily apparent comparable arm's length price can be ascertained because, for example, the debt funding arrangements in question do not reflect commercial and market realities and would not exist between independent parties dealing at arm's length, it is open to the Commissioner, in determining the arm's length consideration, to have regard to the level of debt that the borrowing entity would be able to borrow in an arm's length dealing.[28]

[27] Taxation Rulings TR 94/14 paragraph 338 and TR 97/20 at paragraph 1.15.
[28] Taxation Ruling TR 92/11 says, at paragraph 7(j), that where similar arrangements would not be entered into between unrelated parties, the Commissioner will determine an arm's length consideration on the available information. See also paragraphs 84 and 85 of Taxation Ruling TR 94/14.

Thin capitalisation provisions in Division 820

37. Division 820 is a comprehensive regime whose objective is to ensure that a multinational entity does not allocate an excessive amount of debt to its Australian operations.[29] Paragraph 1.76 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001 (the EM) states that:

> The thin capitalisation rules collectively make up a comprehensive regime. They are specifically directed at debt deductions which, broadly, relate to interest and other costs of borrowing. These features of the regime show that it is intended to cover the whole subject matter to which the thin capitalisation rules apply.

38. Division 820 operates when the amount of debt used to finance the Australian operations exceeds specified limits that determine the maximum level of debt funding of an entity for income tax purposes.[30] It achieves that outcome by denying otherwise allowable debt deductions for an entity in the same proportion to the extent that the entity has excess debt. Excess debt is defined to mean the amount by which the 'adjusted average debt' exceeds the entity's 'maximum allowable debt'.[31] The 'maximum allowable debt' is the greater of certain safe harbour amounts or the amount worked out under a modified arm's length amount test.[32] The statutory safe harbour amount can exceed the arm's length debt amount.[33]

39. Paragraph 820-40(1)(b) provides that, in order for an amount to form part of a debt deduction of an entity, the amount must be a cost incurred by the entity which, apart from Division 820, would be otherwise deductible for that year of income. This principle is repeated at paragraphs 1.58, 1.79, 1.99, 2.98 (Example 2.10) and 3.14 of the EM.

40. Hence, Division 820 is applied to determine the level of debt funding which is permitted – and to disallow the deductions (interest and other costs of borrowing) that an entity may claim apart from Division 820 (for example under section 8-1 of the ITAA 1997 after applying Division 13) – to the extent that the actual level of debt funding exceeds the maximum level permitted under the options in Division 820. It follows that Division 820 can operate to reduce the amount otherwise deductible as the arm's length consideration after the application of Division 13 if, and to the extent that, the actual amount of debt exceeds the 'maximum allowable debt'.

---

[29] Paragraph 1.2 of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 4) 2002.
[30] Paragraph 1.2 of the EM.
[31] For an outward non ADI the excess debt is defined in section 820-115 and for an inward non ADI the excess debt is defined in section 820-220.
[32] For certain entities there is also a world wide gearing test.
[33] For example, refer to section 820-90 for non ADIs.

Relationship between transfer pricing provisions and thin capitalisation provisions in Division 820

41. The EM specifically considered the inter-relationship between the thin capitalisation rules and the transfer pricing provisions. Paragraphs 1.74 and 1.75 of the EM note that:

> 1.74 Some cases will attract the operation of the thin capitalisation rules and the transfer pricing rules in Division 13 of Part III of the ITAA 1936 and comparable provisions of DTAs.
>
> 1.75 A consideration of the scope and purpose of each set of provisions is relevant in determining which provisions are more appropriate to apply in the circumstances of an individual case.

42. Paragraphs 1.78 and 1.79 of the EM add that:

> 1.78 ... the thin capitalisation rules do not have the same scope as Division 13 and comparable provisions of DTAs – the latter apply to a wider range of transactions. Further, there may be instances where the purpose of the application of the arm's length principle under Division 13 and comparable provisions of DTAs to a particular case is not the same as for applying the arm's length test under the thin capitalisation rules. In these cases, the arm's length principle articulated in Division 13 and comparable provisions of DTAs should apply. For example, the application of the arm's length principle to determine whether a rate of interest is greater than an arm's length amount can only be done under Division 13 and comparable provisions of DTAs.
>
> 1.79 ... In normal circumstances, the amount otherwise allowable is that determined under section 8-1 of the ITAA 1997. However, Division 13 and comparable provisions of the DTAs may also impact on the amount otherwise allowable. The thin capitalisation rules apply, therefore, to the amount of a debt deduction which is otherwise allowable having regard to any other provision in the income tax law or in the DTAs.

43. Accordingly, the adjustment of the cost of debt funding to bring it into line with the arm's length principle is consistent with the wording of paragraph 820-40(1)(b) and the policy of that paragraph as articulated in the EM. It follows that an amount otherwise allowable means costs which satisfy all the relevant deductibility provisions of the Act, including the transfer pricing provisions.

44. This interaction is discussed in Taxation Ruling TR 2003/1.[34] The Ruling states that the transfer pricing provisions are left to operate on questions of profit allocation and rates of dealing.[35]

[34] TR 2003/1 Income tax: thin capitalisation – applying the arm's length debt test.
[35] TR 2003/1, at paragraphs 91 to 93.

45. TR 2003/1 further states that the transfer pricing provisions in Division 13 can operate to adjust profits where loans are not on arm's length terms (an excessive interest rate, for example). It also says that in these cases, the arm's length terms and conditions established under Division 13 will be used when conducting the arm's length debt analysis under the thin capitalisation regime. However, the Ruling does not intend that this extends to using Division 13 arm's length capitalisation in Division 820 in the case of entities.[36]

46. The transfer pricing provisions in Division 13 cannot apply to defeat the operation of Division 820 in determining whether an entity's debt levels are excessive for the purpose of disallowing deductions on that excess debt.[37] The Act, read in context, requires Division 820 to operate to achieve its purpose.

47. Except to that extent, Division 820 does not apply to defeat the operation of the transfer pricing provisions in Division 13. An entity cannot circumvent the purpose of the limitation of debt funding in Division 820 by paying above arm's length prices on the lower debt amount. If related entities establish costs above what would be the arm's length cost for the debt funding, the transfer pricing provisions in Division 13 operate in their normal way to allow the costs to be adjusted to the arm's length amount, without causing any conflict with the terms of, and the policy underlying, Division 820.

Provisions relevant to deductibility

48. The operation of Australia's thin capitalisation rules and transfer pricing rules is limited to borrowing costs that the entity can deduct from its assessable income. The deductibility of costs such as interest payments would normally fall for consideration initially under section 8-1 of the ITAA 1997.

49. Such deductions may also be open to challenge under Part IVA of the ITAA 1936. However, Part IVA of the ITAA 1936 will not apply to an entity merely because it has taken advantage of the safe harbour debt amount under Division 820. Part IVA of the ITAA 1936 will apply to a scheme which enables a taxpayer to obtain a tax deduction only if it would be concluded that the dominant purpose of a participant in the scheme was to enable the taxpayer to obtain the deduction, having regard to the criteria specified in section 177D of the ITAA 1936.

[36] Note that for non-bank permanent establishments, the attribution of equity and debt is based on the arm's length principle – see TR 2001/11.

[37] On the basis of the Commissioner's views about acceptable arm's length transfer pricing methodologies for international dealings (see Taxation Ruling TR 97/20), the practical application of the transfer pricing provisions in the tax treaties is not seen as leading to any different outcome.

Appendix 2 – Alternative views

❗ ***This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.***

50. An alternative view is that, where the thin capitalisation provisions under Division 820 do not result in any adjustment to the debt deduction of an entity, the transfer pricing provisions in Division 13 cannot be applied to adjust the pricing of associated costs, such as interest expenses and guarantee fees. The basis for this view is that the thin capitalisation regime in Division 820 is an exclusive code for the purposes of allowing debt deductions and that includes pricing them.

51. The Commissioner does not accept this view. The EM states at paragraph 1.76 that the thin capitalisation rules make up a comprehensive regime in respect of debt deductions. However, paragraph 820-40(1)(b) and paragraph 1.79 of the EM makes it clear that the rules will apply to an amount of a debt deduction which the entity can, apart from Division 820, deduct from its assessable income for that year. The legislation is clearly contemplating amounts which are deductible under all the relevant provisions of the Assessment Act. An amount otherwise allowable would include only those costs which satisfy the arm's length principle embodied in Division 13.

Appendix 3 – Your comments

52. You are invited to comment on this draft Ruling. Please forward your comments to the contact officer by the due date.

53. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the Tax Office website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	**12 February 2010**
Contact officer:	**Andrew Peake**
Email address:	**andrew.peake@ato.gov.au**
Telephone:	**(08) 8208 1839**
Facsimile:	**(08) 8208 1898**
Address:	**Australian Taxation Office** **GPO Box 9977** **Adelaide SA 5001**

Appendix 4 – Detailed contents list

54. The following is a detailed contents list for this Ruling:

	Paragraph
What this Ruling is about	**1**
Previous Draft Determination	**3**
Ruling	**4**
Example 1 – transfer pricing provisions do not defeat the operation of the thin capitalisation provisions	9
Example 2 – transfer pricing provisions can adjust the pricing of debt costs notwithstanding there is no excess debt under the thin capitalisation provisions	14
Date of effect	**17**
Appendix 1 – Explanation	**19**
Transfer pricing provisions	19
Division 13	20
Tax treaties	24
Working out arm's length consideration in relation to debt funding	28
Thin capitalisation provisions in Division 820	37
Relationship between transfer pricing provisions and thin capitalisation provisions in Division 820	41
Provisions relevant to deductibility	48
Appendix 2 – Alternative views	**50**
Appendix 3 – Your comments	**52**
Appendix 4 – Detailed contents list	**54**

References

Previous draft:

TD 2007/D20

Related Rulings/Determinations:

IT 2311; IT 2670; TR 92/11;
TR 94/14; TR 95/23; TR 97/20;
TR 98/11; TR 1999/1;
TR 2001/11; TR 2001/13;
TR 2003/1; TR 2006/10;
TR 2007/1; TD 2002/20

Subject references:

- arm's length capital amount
- arm's length principles
- arm's length transactions
- capitalisation
- debt deductions
- excess debt
- tax treaties
- thin capitalisation
- thin capitalisation arm's length transaction
- transfer pricing

Legislative references:

- ITAA 1936
- ITAA 1936 Pt III Div 13
- ITAA 1936 136AA(1)
- ITAA 1936 136AA(3)(c)
- ITAA 1936 136AB(1)
- ITAA 1936 136AC
- ITAA 1936 136AD
- ITAA 1936 136AD(1)
- ITAA 1936 136AD(2)
- ITAA 1936 136AD(3)
- ITAA 1936 136AD(3)(a)
- ITAA 1936 136AD(3)(b)
- ITAA 1936 136AD(3)(c)
- ITAA 1936 136AD(3)(d)
- ITAA 1936 136AD(4)
- ITAA 1936 Pt IVA
- ITAA 1936 170(9B)
- ITAA 1936 170(9C)
- ITAA 1936 177D
- ITAA 1936 225(2)
- ITAA 1936 226(2B)
- ITAA 1936 226(2C)
- ITAA 1936 226(2D)
- ITAA 1936 226(2E)
- ITAA 1936 226(2F)
- ITAA 1997 8-1
- ITAA 1997 Div 820
- ITAA 1997 820-40
- ITAA 1997 820-40(1)(b)
- ITAA 1997 820-90
- ITAA 1997 820-115
- ITAA 1997 Subdiv 820-C
- ITAA 1997 820-185(3)
- ITAA 1997 820-190
- ITAA 1997 820-195
- ITAA 1997 820-215
- ITAA 1997 820-220
- ITAA 1997 820-305
- ITAA 1997 820-400
- ITAA 1997 995-1
- International Tax Agreements Act 1953
- International Tax Agreements Act 1953 3(2)
- International Tax Agreements Act 1953 Sch 2

Case references:

- Chong v. Commissioner of Taxation (2000) 101 FCR 134; [2000] FCA 635; 2000 ATC 4315; (2000) 44 ATR 295
- Commissioner of Taxation v. Lamesa Holdings BV (1997) 77 FCR 597; 97 ATC 4752; (1997) 36 ATR 589
- GE Capital Finance Pty Ltd v. Federal Commissioner of Taxation (2007) 159 FCR 473; [2007] FCA 558; 2007 ATC 4487; (2007) 66 ATR 447
- McDermott Industries (Aust) Pty Ltd v. Commissioner of Taxation (2005) 142 FCR 134; [2005] FCAFC 67; 2005 ATC 4398; (2005) 59 ATR 358
- Re Roche Products Pty Ltd and the Federal Commissioner of Taxation [2008] AATA 639; 2008 ATC 10-036; (2008) 70 ATR 703
- Undershaft (No 1) Ltd v. Commissioner of Taxation (2009) 175 FCR 150; [2009] FCA 41; 2009 ATC 20-091

Other references:

- Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001

- Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 4) 2002
- Draft Law Administration Practice Statement PS LA 3187

ATO references

NO:	1-1S068SI
ISSN:	1039-0731
ATOlaw topic:	Income Tax ~~ Entity specific matters ~~ transfer pricing Income Tax ~~ Tax integrity measures ~~ thin capitalisation