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Tax Insights

Australia's transfer pricing rules unleashed

Introduction

On 16 March 2023, Treasury released the new debt deduction rules, introducing a range of comprehensive changes to the taxation of debt arrangements in Australia.

As discussed in our Tax Insights ("Exposure draft on new debt deductions rules issued"), the primary focus of the Exposure Draft (Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation) ("ED") is to replace the existing asset-based thin capitalisation rules for "general class investors", **introducing new earnings-based interest limitations based on the OECD recommended approach**.

However, the draft ED includes a number of other important amendments to current law, including the removal of a restriction in the way the current transfer pricing rules apply to the level of debt of taxpayers. Under the proposed changes, for general class investors the **transfer pricing rules will be able to modify the quantum of debt** associated with cross-border financing arrangements in certain circumstances.

All aspects of the ED, including this amendment to the transfer pricing rules, will apply to income years commencing **on or after 1 July 2023**, with no transitional rules or grandfathering, leaving taxpayers with little time to respond to the changes.

This Tax Insights discusses the interaction between the earnings based interest limitation rules and the transfer pricing rules going forward, along with the practical implications of the application of the transfer pricing rules to the debt levels of multinationals operating in Australia.

The current position

Under the current thin capitalisation rules in Division 820 of the Income Tax Assessment Act 1997 (ITAA), an entity's debt deductions are limited to the extent that its adjusted average debt exceeds a maximum allowable debt amount. This amount can be calculated by applying one of three tests – the safe harbour, worldwide gearing or the arm’s length debt test. The safe harbour determines the maximum allowable debt amount based on broadly 60% of average assets and is the most commonly used method in the application of the thin capitalisation rules.

As the thin capitalisation rules disallow debt deductions based on the quantum of debt, a restriction is placed on the current transfer pricing rules in Subdivision 815-B of the ITAA to limit their application with regards to an entity’s level of debt. Where Division 820 applies to an entity and a transfer pricing benefit is obtained in respect of debt deductions, section 815-140 allows the interest rate to be adjusted to an arm’s length interest rate, but that rate must be applied to the debt interest actually issued. The thin capitalisation rules may then further deny debt deductions if the taxpayer’s actual debt amount exceeds the maximum allowable debt amount. Section 815-140 thereby preserves the role of the thin capitalisation rules with regards to an entity’s level of (tax deductible) debt.

In determining the relevant arm’s length interest rate, the hypothetical arm’s length level of debt should still be taken into account. However, these considerations are only relevant to the extent that they impact the interest rate.

Amendment to the transfer pricing rules

The ED introduces three new tests for general class investors (broadly all taxpayers other than financial entities and authorised deposit-taking institutions), specifically:

- The fixed ratio test (FRT), being 30% of tax EBITDA (earnings before interest, taxes, depreciation and amortisation)
- The group ratio test (GRT)
- The external third party debt test (ETPDT).

As the new interest limitation rules under the FRT and GRT deny debt deductions on an earnings basis, as opposed to the level of debt, the abovementioned restriction to the transfer pricing rules will be removed through an amendment to section 815-140. As a result, for entities that are using any of the earnings-based tests, the transfer pricing rules will apply to **both** the interest rate and the level of debt.

The specific transfer pricing provisions that are relevant here include section 815-130(3)(b), which applies when independent entities dealing wholly independently of each other in comparable circumstances would have entered into **other** commercial financial relations and section 815-130(3)(a) where (such) entities **would not have entered** into the commercial and financial relations. It is noted that this is a ‘would test’, however a further complication to consider in this context has been ATO practice in audits to seek to replace actual conditions with arm’s length conditions under section 815-120(1), which does not require a ‘would test’ to be satisfied.

Practically, this means that transfer pricing rules operate independently of the earnings-based limitation rules. If it is determined that the level of debt or the interest rate is inconsistent with arm’s length conditions, resulting in a tax advantage in Australia, the transfer pricing rules will apply to deny all or part of the debt deductions. The adjusted (reduced) amount of debt deductions will then be subject to the new interest limitation rules in Division 820.

Simple example

The following example illustrates the interaction between the interest limitation rules and the transfer pricing rules following these amendments.

Assume that AusCo has borrowed $400 million from an international related party, with an interest rate of 10%. Under the current thin capitalisation rules, AusCo's maximum allowable debt amount is $400 million, and the fixed ratio earnings limit under the new interest limitation rules is $40 million.

Scenarios A and C in the following table illustrates the application of Subdivision 815-B and Division 820 under the current and proposed rules, **assuming** it is determined that both the quantum of debt and the interest rate applied are **consistent** with the arm's length principle.

Scenarios B and D then show the impact of a **transfer pricing adjustment** (again, under the current and proposed rules), **assuming** it is determined that the arm's length conditions include a maximum amount of debt of $300 million, along with an interest rate of 8%.

$ in millions	**Current rules**		**New rules**	
Scenario	**A (No TP adjustment)**	**B (TP adjustment)**	**C (No TP adjustment)**	**D (TP adjustment)**
Total debt	400	400	400	400
Interest rate (actual)	10%	10%	10%	10%
Interest amount	40	40	40	40
Maximum allowable debt	400	400		
30% of tax EBITDA			40	40
Arm's length interest rate	10%	8%	10%	8%
Arm's length debt amount	400	300	400	300
Debt deduction (prior to Division 820)	40	32 (400 X 8%)	40	24 (300 X 8%)
Deduction denied by Subdivision 815-B	**Nil**	**8**	**Nil**	**16**
Deduction denied by Division 820	Nil	Nil	Nil	Nil
Unused capacity per Division 820	n/a	n/a	Nil	16*

* The unused capacity per Division 820 will only be of any benefit if the conditions to carry forward FRT disallowed amounts are met, in which case some or all of that carried forward amount can be deducted in a future year as a "special deduction".

As shown in the table above, the amendment to the transfer pricing rules will have a significant impact on AusCo's allowable debt deductions i.e., reduced debt deductions of $8 million per annum under current rules, compared with a $16 million reduction in debt deductions under the new proposed rules.

Guidance for determining an arm's length level of debt for transfer pricing purposes

Given the present limitations to the application of the transfer pricing rules to debt deductions under section 815-140, there is currently no ATO guidance available on the application of the transfer pricing rules to a borrower's level of debt.

Chapter X of the OECD Transfer Pricing Guidelines (*OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, January 2022*) includes brief commentary on the application of the arm's length principle to the balance of debt and entity funding of an entity within a multinational group, in particular in the context of the OECD's broader guidance on the "accurate delineation" of controlled transactions.

While the OECD provides a list of factors that may be used to determine whether a purported loan should be regarded as a loan for tax purposes (as opposed to a contribution of equity capital), little or no guidance is provided as to the practical application of the arm's length principle in determining an appropriate level of debt. The OECD provides a general example involving a company with an amount of related party debt that exceeds the amount it would be able to borrow from an unrelated party based on its financial forecasts. In this example, the accurately delineated amount of the related party loan for transfer pricing purposes is determined as a function of the maximum amount that an unrelated lender would have been willing to advance to the company, and the maximum amount that an unrelated borrower would have been willing to borrow in comparable circumstances[1].

It should be noted that, while Australia's transfer pricing rules reference the OECD Transfer Pricing Guidelines as relevant guidance material for the identification of arm's length conditions, the latest version of the guidelines, including the abovementioned guidance in Chapter X, has not yet been incorporated as guidance to the interpretation of Australia's transfer pricing rules.

Other than the OECD guidance, elements of the ATO's guidance on the application of the Arm's Length Debt Test[2] in the current thin capitalisation rules may also be of assistance in determining an appropriate amount of debt for transfer pricing purposes. However, there are significant differences between the Arm's Length Debt Test and the arm's length principle under transfer pricing rules and taxpayers should therefore be careful in applying this guidance in a transfer pricing context. For example, the Arm's Length Debt Test requires taxpayers to make a number of factual assumptions to identify an amount of debt for a hypothetical stand-alone Australian business that receives no form of credit support from associates. In contrast, the application of the arm's length principle under the transfer pricing rules requires taxpayers to take into account the Australian borrower's membership of the broader group. This principle was highlighted in Australian case law in the Chevron case (*Chevron Australia Holdings Pty Ltd v Commissioner of Taxation [2017] FCAFC 62*), where the Court held that the Australian borrower should not be treated as an "orphan" for the purposes of applying the transfer pricing rules to an inbound financing arrangement.

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[1] 2022 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, paragraph 10.13

[2] Taxation Ruling 2020/4 - Income tax: thin capitalisation - the arm's length debt test and Practical Compliance Guidelines 2020/7 - ATO compliance approach to the arm's length debt test

Practical implications

The practical implications of the application of the transfer pricing rules to the debt levels of multinationals operating in Australia include:

- Following the introduction of the new rules and the amendments to the transfer pricing rules, Australia will not have a safe harbour for tax deductible debt levels for general class investors. Going forward, such taxpayers will no longer benefit from the certainty provided by the safe harbour in the current thin capitalisation rules. Considering issues relating to the quantum of debt under the transfer pricing rules involves concepts of arm’s length capital structure, the borrower’s and lender’s perspectives, as well as relevance of parental or group credit support, offshore subsidiaries and other assets, which are all open to a greater degree of interpretation. This increased level of uncertainty will also require more complex consideration of appropriate debt levels for new investments or acquisitions going forward.

- Cross-border financing arrangements represent one of the key focus areas of the ATO’s Tax Avoidance Taskforce, and some of the highest profile tax disputes in Australia in recent years have involved debt deductions associated with related party borrowings. The proposed changes will significantly expand the Commissioner’s ability to challenge the financial arrangements of multinationals operating in Australia. Whilst the ATO view of the new draft laws is of course formally unknown, it is reasonable to expect that ATO scrutiny of these transactions will at least be maintained or potentially increase going forward.

- The transfer pricing rules operate on a self-assessment basis. Going forward, general class investors will be required to identify the arm’s length conditions in relation to both the interest rate and the level of debt associated with existing and future debt arrangements, in order to self-assess their transfer pricing positions. Depending on the facts and circumstances, a complex analysis may be required to evaluate the arm’s length nature of debt levels, significantly increasing the compliance burden of general class investors.

- Transfer pricing documentation will generally need to be enhanced to cover the application of Subdivision 815-B to the debt quantum. It is relevant to recollect that in the absence of contemporaneous transfer pricing documentation that meets a range of specific documentation requirements, taxpayers are not eligible to have a reasonably arguable position regarding their transfer pricing positions, which may impact the level of penalties applied in the event of a transfer pricing adjustment.

- Australian transfer pricing adjustments of debt deductions associated with the quantum of debt may result in double taxation for multinational groups. Even though, in principle, where a tax treaty covers the arrangement, the Mutual Agreement Procedure may be available to obtain double tax relief, in practice, a foreign country may disagree with the determination of the arm’s length debt level based on the operation of the transfer pricing rules in Australia, which would result in double taxation.

- Transfer pricing adjustments will likely result in permanent differences between tax and accounting where an amount of funding that is debt for legal and accounting purposes is considered to be in excess of an arm’s length amount of debt.

What should taxpayers do?

The combination of the changes to the thin capitalisation rules and the transfer pricing rules fundamentally changes the landscape for debt deductions in Australia. These changes will apply to income years commencing on or after 1 July 2023, with no transitional rules or grandfathering.

Taxpayers should therefore review their existing and future debt arrangements as a matter of priority, to assess supportability under the transfer pricing rules, and consider options to the extent that there are risks. It is critical that the review takes into account both the application of the new interest limitation rules and the arm’s length nature of the quantum of debt under the transfer pricing rules.

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