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1. Introduction

Intragroup financing to fund business activities by multinational enterprises (***MNEs***) in Australia has long come under intense ATO scrutiny. Whilst much of such attention in the last decade or so has focused on whether borrowings by Australian taxpayers from an international related party are priced appropriately (i.e. whether the interest rate is too high), with the question of how much debt is allowed for Australian tax purposes being addressed through the thin capitalisation provisions, the landscape has now fundamentally changed.

Previous bases for ATO challenge of intragroup financing are now complemented by a broader range of measures of which transfer pricing practitioners and tax managers will need to be cognisant.

The paper addresses the following grounds for the Australian Taxation Office (***ATO***) challenge of an Australian taxpayer's funding structure:

- A key existing basis of ATO challenge of interest rate deductions on related party debt under the transfer pricing provisions involves the imputation of a parental guarantee, but without an accompanying arm's length guarantee fee. The Commissioner has successfully so contended in each of the *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* (***Chevron***)[1] and *Singapore Telecom Australia Investments Pty Ltd v Commissioner of Taxation* (***Singtel***)[2] transfer pricing decisions, and although the Commissioner's transfer pricing challenge was withdrawn and the case proceeded only on Part IVA grounds, also in the Court's preferred Part IVA counterfactual in *Mylan Australia Holding Pty Ltd v Commissioner of Taxation (No 2)* (***Mylan***).[3] Sections 2.1 and 2.2 of this paper examine the case law and legislation in relation to this issue, including, importantly, the potential for a taxpayer to successfully argue that no transfer pricing benefit actually arises in such case. This might be on the basis that, if a guarantee is to be imputed, so too should an arm's length guarantee fee. This section also addresses arguments as raised in the special leave application to the High Court in the *Singtel* case that, where a Double Tax Agreement (***DTA***) is applicable, the imputation of a guarantee without also an arm's length guarantee fee is in contravention of the associated enterprises article. It is the Commissioner's success in *Chevron* (and subsequently in *Singtel*, to date) that underpins the Commissioner's approach in PCG 2017/4. That approach, in essence, seeks to have Australian taxpayers only claim interest deductions at or close to their parent group's cost of funds. This is on the basis that a parental guarantee will harmonise, or near harmonise, the borrowing subsidiary's credit rating with that of its parent, and, thus, its cost of borrowing.
- However, in addition to the parental guarantee arguments arising from *Chevron*, *Singtel* and *Mylan*, the amendment of the thin capitalisation transfer pricing modification provision in s 815-140, in relation to general class investors, now gives the Commissioner an entirely new basis for challenging the capital or funding structure of an Australian subsidiary of a

[1] *Chevron Australia Holdings Pty Ltd v Federal Commissioner of Taxation (No 4)* (2015) 102 ATR 13 (***Chevron first instance decision***); *Chevron Australia Holdings Pty Ltd v Federal Commissioner of Taxation* (2017) 251 FCR 40 (***Chevron appeal decision***).

[2] Singapore Telecom Australia Investments Pty Ltd v Commissioner of Taxation (2021) 114 ATR 51 (***Singtel first instance decision***); *Singapore Telecom Australia Investments Pty Ltd v Commissioner of Taxation* (2024) 302 FCR 192 (***Singtel appeal decision***).

[3] *Mylan Australia Holding Pty Ltd v Federal Commissioner of Taxation (No 2)* [2024] FCA 253 (***Mylan***). Although, note the Commissioner was ultimately unsuccessful in relation to the application of Part IVA, given the absence of the requisite purpose of obtaining a tax benefit.

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multinational group for transfer pricing purposes. The former thin capitalisation rules operated to determine the maximum allowable *amount* of debt. To harmonise the thin capitalisation and transfer pricing provisions, prior to its amendment, s 815-140 effectively 'disapplied' the arm's length conditions test in Subdivision 815-B of the *Income Tax Assessment Act 1997* (Cth) (the ***ITAA 1997***) in relation to the *quantum* of the debt interest. A taxpayer would, theoretically, need to determine the arm's length amount of debt to determine the arm's length amount of interest on that arm's length amount of debt, but could then, for the purposes of the transfer pricing provisions, apply that interest rate to the actual amount of debt issued. Practically, one suspects, however, that, so long as taxpayers were within the quantum of debt allowed by the then existing thin capitalisation provisions (and were relying on the 60% safe harbour and not the arm's length debt test) most taxpayers did not devote considerable resources to determining whether their balance sheet or funding structure was actually arm's length. As the new thin capitalisation provisions now deny debt deductions on an earnings (not assets) basis (30% of 'Tax EBITDA'), for general class investors, s 815-140 is now 'switched off'. Accordingly, the amount of debt (and so the level of gearing) is now a relevant condition for the purposes of determining whether it is arm's length under the transfer pricing provisions. Taxpayers will no longer need to consider only whether the price or interest rate is right, but also whether the quantum or amount of debt, i.e. the capital structure itself, is arm's length. If the actual amount of debt exceeds the arm's length amount of debt, the Commissioner will be able to deny debt deductions on the excess under the transfer pricing provisions (with the thin capitalisation fixed ratio test then applying as an additional test). Interesting questions now arise (upon which ATO and potentially case law guidance is needed) as to how to determine the arm's length amount of debt. For example, is the arm's length amount of debt the amount that the Australian subsidiary can borrow or might be reasonably expected (within a range) to be able to borrow without a guarantee from its parent (or, instead, the amount that it could borrow with a guarantee)? Does the arm's length amount represent the Australian borrower's actual borrowing capacity, or should that be adjusted in some way, as the ATO might suggest, to reflect the gearing of the taxpayer's independent peers operating in the same industry or segment? Section 2.3 of this paper addresses the consequences of the modification of s 815-140 for taxpayers in relation to intragroup financing arrangements.

- Recent cases have involved the ATO challenging funding structures under both the transfer pricing provisions and also under the General Anti-Avoidance Rule (the ***GAAR***) in Part IVA of the *Income Tax Assessment Act 1936* (Cth) (the ***ITAA 1936***). However, the debt deduction creation rules (***DDCR***) in new Subdivision 820-EAA, which apply to income years starting on or after 1 July 2024, arm the Commissioner with a new tool that may render such (evidence intensive) challenges otiose where the proceeds of the intragroup debt has been applied for particular purposes. The DDCR will deny debt deductions on intragroup debt for entities that are subject to the thin capitalisation rules in two cases:

    - **borrowing from an associate to fund an acquisition from an associate**: Where debt deductions are incurred by an entity, or one of its associates, in relation to the acquisition or holding of a CGT asset, or a legal or equitable obligation acquired from an associate pair and the debt deduction is referable to an amount paid or payable to an associate pair of the borrower or the acquirer; and

    - **borrowing from an associate to fund certain types of payments or distributions to an associate entity**: where the debt deductions relate to an entity borrowing from an associate pair to fund or facilitate the funding of certain

types of payments or distributions (e.g. a dividend, a return of capital, a royalty or certain types of loan repayments) to an associate pair.

The DDCR, and the anti-avoidance rule associated with it, are described in Section 3 of this paper.

- Once the transfer pricing rules and the DDCR have been addressed, an analysis of debt deductions in respect of intragroup (and other) debt, will need to consider the operation of the new thin capitalisation rules. These provisions introduced new earnings based tests for general class investors. A fixed ratio test replaces the former asset based safe harbour test (and a group ratio test replaces the former worldwide gearing test). A third party debt test is also introduced for general class investors and financial entities that are not ADIs. The new thin capitalisation provisions are addressed in Section 4 of the Paper.
- Taxpayers and their advisers will also have to address the prospect of the Commissioner applying the GAAR as contained in Part IVA of the ITAA 1936 to challenge a funding structure (as occurred in *Mylan*). Section 5 of the Paper addresses some Part IVA issues associated with cross-border intragroup capital structures, and the *Mylan* case in further detail.
- Section 6 of the Paper briefly addresses the interaction between the above rules.

Additionally, taxpayers will need to address a range of other issues including: the taxation of financial arrangements (or 'TOFA') rules, the hybrid mismatch rules, the debt/equity rules, the diverted profits tax and the tax treaty overlay. These topics are outside the scope of this paper.

2. The application of particular aspects of the transfer pricing rules to intragroup financing arrangements

2.1 Overview of the Australian transfer pricing regime

Australia's current transfer pricing provisions are contained in Subdivisions 815-B and 815-C of the ITAA 1997. The transfer pricing rules in Subdivision 815-B broadly provide for the substitution in of arm's length conditions for income tax purposes where an entity obtains a transfer pricing benefit from non-arm's length conditions that operate between it and another entity in connection with their commercial or financial relations.[4]

The rules under Subdivision 815-B of the ITAA 1997 apply to income years starting on or after 29 June 2013. Subdivision 815-B succeeds the transfer pricing regime as contained in Subdivision 815-A of the ITAA 1997, which applied (retrospectively) from 1 July 2004, concurrently with former Division 13 of the ITAA 1936, which applied from 27 May 1981 until its repeal (and the repeal of Subdivision 815-A) in relation to income years starting on or after 29 June 2013.

In considering whether an entity obtains a transfer pricing benefit from conditions that operate between the entity and another entity in connection with their commercial or financial relations, broadly, one must consider:[5]

- whether the actual conditions differ from arm's length conditions;
- whether the actual conditions satisfy the cross-border test in s 815-120(3) (which would be satisfied if one or both of the entities is not an Australian resident); and
- broadly speaking, had the arm's length conditions operated instead of the non-arm's length conditions, whether the entity's taxable income for an income year would have been greater.[6]

If a taxpayer receives a transfer pricing benefit, the arm's length conditions are taken to operate in substitution of the actual conditions.[7] This entails working out the taxpayer's taxable income, loss, offset or withholding tax, as the case may be, had arm's length conditions applied.[8]

Section 815-110(1) of the ITAA 1997 contains an override clause that ensures the transfer pricing rules prevail over other provisions in the Australian income tax law where a conflict arises. This means that if the application of Subdivision 815-B results in a different outcome from the provisions of other parts of the law, the arm's length conditions determined under Subdivision 815-B will take precedence. This reinforces the primacy of the transfer pricing provisions in ensuring that income is taxed in accordance with arm's length principles. However, s 815-110(2) provides that nothing in

[4] ITAA 1997 s 815-115.
[5] ITAA 1997 s 815-120.
[6] Or its loss of a particular sort would be less, its tax offsets would be less or its withholding tax would be greater: ITAA 1 997 s 815-120(1)(c).
[7] ITAA 1997 s 815-115(1).
[8] ITAA 1997 s 815-115(2).

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Subdivision 815-B limits the thin capitalisation regime in Division 820 in its application to reduce, or further reduce, debt deductions of an entity.

The 'basic rule' in s 815-130 provides that the identification of the arm's length conditions must be based on the commercial or financial relations in connection with which the actual conditions operate and to have regard to both the form and substance of these relations, unless certain exceptions apply. Those exceptions only allow the actual commercial or financial relations to be disregarded if their form is inconsistent with the substance of those relations, or, if independent parties dealing wholly independently with one another would not have entered into those actual commercial or financial relations and would have entered into other commercial or financial relations (or would not have entered into commercial or financial relations).

While the transfer pricing rules under former Division 13 and Subdivision 815-A require a determination on the part of the Commissioner as part of their application,[9] the transfer pricing rules under Subdivision 815-B are self-executing in operation.[10]

Amended assessments giving effect to Subdivision 815-B may be made within seven years of a notice of assessment to the entity by the Commissioner.[11]

2.2 *Chevron*, *Singtel* and the imputation of parental guarantees

Applying the transfer pricing rules to an intragroup financing arrangement entails consideration of the conditions which would have applied to such a financing arrangement if undertaken at arm's length. The Full Federal Court in *Chevron* confirmed that under Australian transfer pricing law, where a taxpayer is part of a multinational corporate group, the hypothetical taxpayer considered for the purposes of the transfer pricing hypothetical should similarly be considered to be a subsidiary of such a group (i.e. the Court rejected the 'orphan theory'). So, for the purposes of a transfer pricing analysis of an intragroup financing the hypothetical borrower may have attributes of that group relationship attached to its identity for the purposes of constructing an arm's length hypothetical scenario with which to compare the actual scenario. This may entail the credit rating of a taxpayer being 'notched up' to reflect the understanding that a taxpayer, were it borrow at arm's length, would have had the implied financial support of a parent company available. Further, the Courts have in *Chevron* and *Singtel* imputed an *express* parental guarantee into the transfer pricing hypothetical. At arm's length, a third-party lender would typically charge a higher interest rate to a subsidiary who does not have the financial support of a parent. Australian courts have held that 'an explicit, enforceable, unconditional guarantee of a debt obligation' by a parent company may 'notch up' the credit rating of a subsidiary such that it is 'equalised with that of the parent'.[12] This would enable a subsidiary to access a lower cost of borrowing in a hypothetical arm's length borrowing scenario.

In determining whether a parental guarantee would have reasonably been expected in an arm's length hypothetical in *Chevron*, the Full Federal Court appeared to place weight on evidence of a group policy. In that case, evidence was adduced which showed that it was the parent's policy that external borrowings were to be done at the lowest possible interest rate, and that the parent's usual commercial policy was to provide a guarantee for external borrowings by subsidiaries.[13] In the appeal decision Allsop CJ stated:

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[9] ITAA 1936 former s 136AD; ITAA 1997 s 815-10.
[10] ITAA 1997 s 815-115(1).
[11] ITAA 1997 s 815-150.
[12] Singtel first instance decision, 104 [210].
[13] Chevron appeal decision, 56 [62] (Allsop CJ).

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> If the evidence reveals (as it did here) that the borrower is part of a group that has a policy to borrow externally at the lowest cost and that has a policy that the parent will generally provide a third party guarantee for a subsidiary that is borrowing externally, there is no reason to ignore those essential facts in order to assess the hypothetical consideration to be given.[14]

However, there is debate as to the true *ratio decidendi* of *Chevron*. The facts in *Chevron* were such that the borrower would not have been able to borrow the amount that it did were it to do so hypothetically from independent parties without security, such as the provision of a parent company guarantee.[15] This informed the finding that 'it would not reasonably be expected that the loan would have been made without security or a parent guarantee and, accordingly, the arm's length consideration could not be reliably established by reference to "an agreement" which did not contain those features'.[16]

There remains a question as to whether *Chevron* is authority for the proposition that an express parental guarantee can in fact be imputed into the arm's length hypothetical in circumstances were the Australian subsidiary could have borrowed the amount actually borrowed at arm's length without the support of a parental guarantee. Thus, in his judgment in the Full Federal Court appeal in *Federal Commissioner of Taxation v Glencore Investment Pty Ltd* (***Glencore***),[17] Thawley J discussed the approach for identifying arm's length conditions under former Division 13 in *Chevron* and the propositions that *Chevron* does and does not stand for. At paragraph 262, Thawley J stated as follows (emphasis added):

> The more the hypothetical agreement required to be posited by s 136AA(3)(c) ('an agreement') departs from the terms of the international agreement under which the supply of property occurred, the less the hypothetical agreement is apt to reveal 'the consideration that might reasonably be expected to have been received or receivable as consideration in respect of the supply if the property had been supplied under an agreement between independent parties dealing at arm's length with each other in relation to the supply'. **Whilst the Commissioner can, as a matter of law, 'substitute' terms or undertake the statutory task by reference to 'an agreement' which is different from the 'international agreement', the greater the substitution of terms or the more different the hypothetical agreement is from the international agreement, the less likely it is that the hypothetical agreement is probative of the arm's length consideration for the supply of the property under the international agreement which engaged Div 13. It is one thing to determine the arm's length consideration by reference to 'an agreement' which substitutes terms which would not be found in an international agreement between independent parties dealing with each other at arm's length (or to add terms — such as security and covenants — which would have existed if the international agreement had been between independent parties dealing at arm's length as in *Chevron*); it is another to determine the arm's length consideration by reference to 'an agreement' which ignores terms in the international agreement which are terms to which independent parties dealing at arm's length would have agreed (this case).**

At paragraph 269 his Honour further elaborated on the principles arising from *Chevron* as follows (emphasis added):

> At the risk of oversimplification, that is what Chevron decided: a reasonable expectation that the consideration is an arm's length one is not proved by establishing the consideration which would

[14] Ibid 56 [63] (Allsop CJ).
[15] Chevron first instance decision, 74 [205].
[16] Singtel appeal decision, 454 [279].
[17] *Federal Commissioner of Taxation v Glencore Investment Pty Ltd* (2020) 112 ATR 378 (***Glencore***).

> be received under an agreement to which independent parties dealing at arm's length would never have agreed. **Chevron is not authority for the proposition that the arm's length consideration for the purposes of Div 13 may reliably be determined by ignoring or substituting arm's length terms. An assessment would likely be excessive if it were issued on the basis of 'an agreement' which departs from terms in the 'international agreement' which both affect consideration and might reasonably be expected between independent parties dealing with each other at arm's length in relation to the supply.** If the arm's length consideration is determined by reference to such 'an agreement', then the issue raised by s 136AD(1)(c) would not have been reliably answered because the ignored terms of the 'international agreement' which engaged the operation of Div 13 might reasonably have been expected in 'an agreement' between independent parties dealing at arm's length.

Thus, if an Australian subsidiary in the position of the borrower could have or might reasonably be expected to have borrowed the amount actually borrowed at arm's length without a parental guarantee, there remains a question as to whether a parental guarantee can be imputed for the purposes of the relevant hypothetical under Australian transfer pricing laws.

Accordingly, whether or not the relevant arm's length hypothetical should include a parental guarantee may depend on the facts and circumstances of the particular case and the particular taxpayer including its borrowing capacity, and potentially also relevant group policies. In *Singtel*, Moshinsky J found that the significantly higher interest rate that would have applied to the loan of the subsidiary in the absence of a parent company guarantee would have compelled the parent company to have provided such a guarantee in relation to an arm's length borrowing.[18] The Full Federal Court found that the inclusion of a guarantee in the arm's length hypothetical on that basis 'is not inconsistent with the application of the statutory provisions'.[19]

In *Singtel*, evidence was not adduced in relation to the parent company's policy around provision of guarantees to subsidiaries. However, Moshinsky J held that he did not consider the existence of such a policy to be 'essential to a hypothesis that there might be expected to be a parent guarantee'.[20] Moshinsky J preferred to focus on the 'logic of the situation', which in this case 'strongly point[ed] to a parent guarantee being provided'.[21] These views were not addressed by the Full Federal Court on appeal.

Where it is found that a borrower would have had a parental guarantee under an arm's length hypothetical, a question arises as to whether that borrower would have paid a guarantee fee to that parent company. Where the Commissioner is seeking to argue that the interest rate actually paid under an intragroup financing was not arm's length, and that at arm's length the subsidiary would have had been supported by a parent company guarantee from a parent with a higher credit rating (and therefore the subsidiary would have had access to borrowings at lower interest rates), the finding that the subsidiary would have paid a guarantee fee to its guaranteeing parent at arm's length is an additional borrowing cost in the hypothetical scenario. In practical terms this may operate to close the gap between the actual cost of borrowing and the cost of borrowing which the subsidiary would have been subject to with a guarantee.

[18] Singtel first instance decision, 124 [324].
[19] Singtel appeal decision, 248 [257].
[20] Singtel first instance decision, 126 [327].
[21] Ibid 125 [324].

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As observed by Pagone J in the Full Federal Court in *Chevron*, the OECD Transfer Pricing Guidelines 'contemplate that a cross-border guarantee by a parent to a subsidiary may require the payment of an arm’s length guarantee fee'.[22]

In the 2022 version of the Guidelines, this is evident in Chapter X:

> Where the effect of a guarantee is to permit a borrower to borrow a greater amount of debt than it could in the absence of the guarantee, the guarantee is not simply supporting the credit rating of the borrower but could be acting both to increase the borrowing capacity and to reduce the interest rate on any existing borrowing capacity of the borrower. In such a situation there may be two issues — whether a portion of the loan from the lender to the borrower is accurately delineated as a loan from the lender to the guarantor (followed by an equity contribution from the guarantor to the borrower), and whether the guarantee fee paid with respect to the portion of the loan that is respected as a loan from the lender to the borrower is arm’s length. The conclusion of an analysis of such transactions may be, taking into account the full facts and circumstances, that the evaluation of the guarantee fee should be limited to a fee on the portion that has been accurately delineated as a loan, and the remainder of the loan granted should be regarded as effectively a loan to the guarantor followed by an equity contribution by the guarantor to the borrower.

However, Australian courts have not to date (on the particular facts of the cases before them) found hypothetical guarantee fees as having been payable in relation to hypothetical guaranteed borrowings.

- In *Chevron*, Pagone J contemplated that it was possible that an arm's length hypothetical might include a guarantee fee in certain circumstances. However in that case his Honour found that 'there was insufficient evidence on the case as conducted to warrant the conclusion that a fee might reasonably have been expected'.[23]
- In *Singtel*, Moshinsky J at first instance found that there had been a failure on the part of the taxpayer to provide 'any probative evidence to hypothesise that, assuming the provision of a parent guarantee, a guarantee fee might be expected to be charged', and that, additionally, the Singtel parent had not provided a guarantee fee to subsidiaries undertaking actual third party loans.[24] The Full Federal Court agreed with Moshinsky J's findings, noting that 'no error has been demonstrated in the reasoning of the primary judge to the effect that a fee would not be payable'.[25]
- In *Mylan*, the broader financing arrangement entailed a guarantee actually having been provided by the Mylan parent in support of borrowing by various Mylan subsidiaries, and in those instances, no guarantee fee was in fact charged by the Mylan parent. On this basis, Button J concluded, that for the purposes of a hypothetical guaranteed borrowing (but in the context of a Part IVA rather than a transfer pricing hypothetical), the Mylan parent 'would likewise not have charged any guarantee fee'.[26]

However, it remains to be seen the extent to which probative evidence demonstrating that a parent might reasonably be expected to charge a subsidiary a guarantee fee in the context of an arm's length

[22] Chevron appeal decision, 78 [133] (Pagone J).
[23] Ibid.
[24] Singtel first instance decision, 126 [328]
[25] Singtel appeal decision, 248 [259].
[26] Mylan, 106–7 [390].

hypothetical, could sway an Australian court to such a finding (i.e., that an arm's length guarantee fee should be imputed).

One potential type of evidence (canvassed in passing in oral argument in the *Singtel* Full Court appeal hearing) is where the transfer pricing laws of the foreign jurisdiction require the hypothetical guarantor to return an arm's length guarantee fee for income tax purposes. In circumstances where the guarantor might be assessed to tax on an arm's length guarantee fee even if it was not paid, it might reasonably be expected for the purposes of a transfer pricing hypothetical that the guarantor would require the payment of such a fee, and the subsidiary whose borrowings were guaranteed might be reasonably be expected to pay the guarantee fee, if its total borrowing costs were still lesser than if it borrowed without a guarantee. This would be consistent with the OECD approach outlines above and also with the arm's length principle upon which the transfer pricing provisions are based.

In the *Singtel* High Court special leave application,[27] Singapore Telecom Australia Investments Pty Ltd (***STAI***) as the applicant raises the argument that, where an arm's length hypothetical imputes a guaranteed borrowing, a corresponding guarantee fee should also be imputed.

STAI raises the argument that failure to impute an arm's length guarantee fee in the context of a guaranteed hypothetical is contrary to Australia's transfer pricing statutory provisions and the associated enterprises article of the DTA between Australia and Singapore.[28] This is because it contradicts the 'arm's length principle' (of which the associated enterprises article is said to be the authoritative expression) within its understood meaning under international law, including as expressed under the OECD Transfer Pricing Guidelines (2022). STAI has argued that, where the relevant arm's length scenario hypothesised for transfer pricing purposes is found to entail a parent company guarantee, it is by necessary application of the arm's length principle that such a guarantee should also entail an arm's length guarantee fee charged by the parent to the borrowing subsidiary. STAI refers to paragraph 7.13 of the OECD Transfer Pricing Guidelines, which states that an intragroup guarantee is a compensable service. Additionally, STAI refers to foreign case law which finds that the provision of a parental guarantee to a foreign subsidiary is compensable where it results in a lower cost of borrowing.[29]

In his response to STAI's special leave application, the Commissioner states that 'there was insufficient evidence to warrant the conclusion that a fee might reasonably have been expected to have been paid' and that 'ultimately, this case is no vehicle for any guarantee fee legal issues'.

The High Court special leave application for *Singtel* is anticipated to be heard on 25 October 2024. Should the guarantee fee issue be ventilated in the High Court, taxpayers may find much greater clarity around the application of the transfer pricing rules to intragroup financing arrangements. If the High Court finds that a *Singtel* appeal is not an appropriate vehicle under which to consider these issues, then uncertainty may remain with the treaty point, and the related point as to whether a taxpayer can adduce sufficient evidence that it might reasonably have expected that a guarantee fee would be paid, would be left otherwise unresolved.

[27] *Singapore Telecom Australia Investments Pty Ltd v. Commissioner of Taxation*, Form 23 – Application for leave or special leave to appeal (5 April 2024).
[28] Ibid.
[29] *Canada v General Electric Capital Canada Inc* 2010 FCA 344.

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2.3 Section 815-140 amendment

Whereas previously s 815-140 of the ITAA 1997 reserved the question of the quantum of debt for the thin capitalisation regime in Division 820, this is no longer the case for general class investors following the recent amendment to the provision by the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Act 2024* (Cth) (the ***Treasury Laws Amendment 2024***). The provision now empowers the Commissioner to scrutinise both the *interest rate* and the *amount of debt* in intragroup financing arrangements using transfer pricing provisions.[30] This change significantly bolsters the ATO's arsenal for limiting interest deductions in relation to intragroup financing arrangements.

The Treasury Laws Amendment 2024 applies in this respect from 1 July 2023.

The interaction between the transfer pricing and thin capitalisation regimes has, in the past, been a vexed issue. Specifically, whether the transfer pricing provisions not only operated to alter the rate of interest on debt but also the amount of debt in an intragroup financing arrangement for tax purposes.

This ambiguity resulted in the ATO, between 2007 and 2010, releasing several guidance publications aimed at clarifying the issue.[31] Thereafter, from 2012, the legislature introduced various thin capitalisation modification provisions, including s 815-25 in the context of Subdivision 815-A, s 815-140 in the context of Subdivision 815-B and s 177J(4)–(5) in the context of the diverted profits tax (***DPT***),[32] effectively disapplying the transfer pricing rules (and the DPT rules) in relation to the amount of debt (although making that a relevant consideration for determining the arm's length interest rate, which was then applied to the actual amount of debt).[33]

And now, pursuant to the new thin capitalisation regime, which shifts the interest deduction limitation test from an asset-based approach to an earnings-based approach for certain entities, Parliament has said that the rationale for constraining the transfer pricing rules such that they cannot alter the amount of debt for tax purposes no longer exists.[34]

As a result, the Commissioner can now argue, pursuant to the transfer pricing rules, that, if an entity is relatively highly leveraged, part of its debt might be beyond an arm's length amount of debt, and should be treated, in effect, as quasi-equity (or at least not as bearing interest deductions for tax purposes).

That said, it is not immediately clear how exactly the arm's length amount of debt is to be determined — is the debt unguaranteed, implicitly guaranteed or guaranteed with an attached guarantee fee? Alternatively, does the arm's length amount of debt reflect the borrower's actual borrowing capacity or should it be adjusted to reflect industry standards as to leverage?[35]

This section describes the context to the initial introduction of the thin capitalisation saving or modification provisions for transfer pricing, and the recent amendment 'turning off' these provisions for

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[30] Treasury Laws Amendment 2024 sch 2 s 10.

[31] TD 2007/D20; Australian Taxation Office, *Intra-group Finance Guarantees and Loans* (Discussion Paper, June 2008); TR 2010.

[32] The modification relating to the diverted profits tax was not amended by the Treasury Laws Amendment 2024 and still applies.

[33] Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No. 1) 2012 (Cth); Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013 (Cth).

[34] Treasury Laws Amendment 2024 sch 2 s 10.

[35] See Jarrod Thomas and Bill Yohana, 'Intra-group Financing — Transfer Pricing Rules Unleashed' (Conference Paper, National Transfer Pricing Conference, 18 October 2023).

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general class investors, and its potential implications, specifically focusing on s 815-140 in the context of Subdivision 815-B.

2.3.1 Prior to the s 815-140 concession

In November 2007, the ATO released TD 2007/D20 entitled 'Income tax: where there is no excess debt deduction under Division 820 of the *Income Tax Assessment Act 1997* can the transfer pricing provisions apply to adjust the pricing of costs that may become tax deductions, for example, interest and guarantee fees?' In TD 2007/D20, the Commissioner expressed his view that:

> the transfer pricing provisions 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 that extent it is accepted that Division 820 modifies the operation of the arm's length principle embodied in the transfer pricing provisions.[36]

It followed for the Commissioner, as was explained in an ATO Discussion Paper dated June 2008 entitled 'Intra-group Finance Guarantees and Loans', that 'the level of debt is not subject to adjustment under the transfer pricing rules'.[37] The provisions then under consideration were in former Division 13 of the ITAA 1936.

The Commissioner maintained this view in TR 2009/D6 (entitled 'Income tax: the interaction of Division 820 of the ITAA 1997 and the transfer pricing provisions in relation to costs that may become debt deductions, for example, interest and guarantee fees'), which ruling was later finalised in TR 2010/7 (entitled 'Income tax: the interaction of Division 820 of the ITAA 1997 and the transfer pricing provisions').

In TR 2010/7, the Commissioner articulated his opinion about the way in which Australia's thin capitalisation regime (in Division 820) and transfer pricing regime (in Division 13) interacted:

> 9. Division 820 addresses only the amount of debt an entity can have for purposes of deductibility of its debt deductions, while the transfer pricing provisions alone deal with the pricing of the consideration given for this debt.
>
> 10. Accordingly, where an entity does not have 'excess debt', such that the thin capitalisation provisions in Division 820 would not result in the disallowance of any portion of the amounts comprising an entity's 'debt deduction', the transfer pricing provisions can still be applied to adjust the pricing of the consideration given to obtain and maintain the debt funding. Such costs could include interest expenses, discounts on commercial paper, guarantee fees or other costs that are directly incurred in relation to the debt.[38]

Additionally, in discussing the approach to calculating the arm's length interest rate, TR 2010/7 outlined:

> 55. One possible approach in this circumstance, though not necessarily the only approach, is to price an amount of debt by having regard to the amount of debt that the taxpayer would

[36] TD 2007/D20, [2].
[37] Australian Taxation Office, *Intra-group Finance Guarantees and Loans* (Discussion Paper, June 2008), 2.
[38] TR 2010/7, [9]–[10].

> reasonably be expected to have if it was dealing at arm's length with other parties. This might be necessary, for example, 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.[39]

Notwithstanding the Commissioner's administrative approach set out in TR 2010/7, some doubt as to the proper interaction between the thin capitalisation and transfer pricing provisions remained. This doubt prompted calls in the context of the Treasury Consultation Paper dated 1 November 2011 entitled 'Income Tax: Cross Border Profit Allocation — Review of Transfer Pricing Rules', for the legislature to provide certainty on the interaction between the two regimes.[40]

It was within that context that s 815-25 was enacted (in relation to Subdivision 815-A). It provided:

> **Modified transfer pricing benefit for thin capitalisation**
>
> (1) This section modifies the transfer pricing benefit an entity gets, or apart from this section would get, in an income year if:
>
> (a) Division 820 (about thin capitalisation) applies to the entity for the income year; and
>
> (b) the transfer pricing benefit relates to profits, or a shortfall of profits, referable to costs that are *debt deductions of the entity for the income year.
>
> (2) If working out what those costs might have been, or might be expected to be, involves applying a rate to a debt interest:
>
> (a) work out the rate by applying section 815-15, having regard to section 815-20; but
>
> (b) apply the rate to the debt interest the entity actually issued.

The Explanatory Memorandum to the Bill introducing s 815-25 observed that it was intended to be a 'special rule' aligned 'with the current administrative approach provided in TR 2010/7'.[41]

As well, the Explanatory Memorandum, in discussing the approach to calculating the arm's length interest rate under s 815-25(2), suggests a similar approach to that in paragraph 55 of TR 2010/7 (as discussed above) and states:

> 1.108 The interaction of Subdivision 815-A with Division 820 operates as follows.
>
> - Firstly, to the extent relevant, the arm's length rate applying to a debt interest is determined in accordance with the normal rules contained in section 815-15. In doing so, it will be necessary to consider (for an associated entity) the conditions operating between the entity and its associate(s) in their commercial and financial relations. The arm's length rate may need to be determined by having regard to the conditions which

[39] TR 2010/7, [55].

[40] Explanatory Memorandum to the Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012, [1.105]. See also: PwC, Submission to Treasury's *Income Tax: Cross Border Profit Allocation: Review of Transfer Pricing Rules* (30 November 2011) 12-13. That doubt may have been heightened by an opinion given by Ron Merkel KC and Dianna Harding to the Commissioner that, contrary to the approach ultimately adopted in TR 2010/7, the interest rate determined on the arm's length debt amount is to be applied *only* to the arm's length debt amount, and not the actual amount of debt, so as not to 'overstate [the] arm's length consideration': see Merkel and Harding, *Transfer Pricing Supplementary Memorandum of Advice*, 23 June 2009, [16](b).

[41] Explanatory Memorandum to the Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012 (Cth), [1.105] (***Subdivision 815-A EM***).

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could be expected to operate between entities dealing wholly independently with each other. For example, in some exceptional cases (as provided by the relevant OECD guidance material), it may be appropriate to determine the arm's length rate having regard to the amount of debt the entity is likely to have had, had the conditions operating between it and its associate(s) been aligned to what they would have been if the entities had been independent of each other. Alternatively, it may be possible to determine an arm's length rate, directly or indirectly, by some other means without having to determine an arm's length amount of debt. Whether an entity's amount of debt meets the safe harbours provided for the purposes of Division 820 is not relevant for this first step.

- Secondly, the arm's length rate is applied to the entity's actual amount of debt. The result of this second step would be used by the Commissioner in determining the amount of the transfer pricing benefit (if any) to be negated. The amount of debt deductions of the entity remaining after the transfer pricing benefit has been negated is the amount which would be otherwise allowable under this Subdivision, and which then becomes the amount of debt deductions to be considered for the purposes of Division 820.
- Finally, and after the consideration of any other part of the income tax law as may be necessary, Division 820 may reduce an entity's otherwise allowable debt deductions if in the case of a non-Authorised Deposit-taking Institution, the entity's adjusted average debt exceeds its maximum allowable debt.

In essence, the approach involves determining the arm's length interest rate, which may in some cases require considering an arm's length debt amount, but not always. This rate is then applied to the actual debt amount, with further considerations under Division 820 potentially applicable.

2.3.2 Introduction of s 815-140

Subsequently, s 815-140 was enacted, along with the addition of Subdivision 815-B in 2013.[42] The Explanatory Memorandum to the Bill introducing s 815-140 observed that: 'the rule maintains the administrative approach under Taxation Ruling TR 2010/7, which was confirmed in Subdivision 815-A'.[43]

Similarly and in effect, s 815-140 served as a concession that the transfer pricing rules would not alter the quantum of debt for tax purposes, as this was considered to fall within the remit of the thin capitalisation provisions — considered a 'comprehensive regime' in respect of its application to an entity's amount of debt.[44] In other words, if a quantum of debt was within thin capitalisation limits, then it was deemed acceptable for transfer pricing purposes, effectively shielding the debt amount from further challenge under Subdivision 815-B. However, determining the arm's length amount of debt is relevant to determining the arm's length interest rate under the provisions.

Specifically, s 815-140, prior to its recent amendment, provided:

Modification for thin capitalisation

[42] There are some minor textual different between ss 815-25 and 815-140 designed to ensure harmony between the thin capitalisation modification provisions and the respective Subdivisions in which they reside.
[43] Explanatory Memorandum to the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 (Cth) [3.145] (***Subdivision 815-B EM***).
[44] Subdivision 815-B EM, [3.144].

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(1) This section modifies the way an entity to which section 815-115 applies works out its taxable income, or its loss of a particular *sort, for an income year, if:

(a) Division 820 (about thin capitalisation) applies to the entity for the income year; and

(b) the *arm's length conditions affect costs that are *debt deductions of the entity for the income year.

(2) If working out what those costs would be if the *arm's length conditions had operated involves applying a rate to a *debt interest:

(a) work out the rate as if the arm's length conditions had operated; but

(b) apply the rate to the debt interest the entity actually issued.

The process for calculating the arm's length interest rate under s 815-140(2) is the same as set out above in relation to s 815-25(2), particularly the need, in most cases, to calculate the arm's length amount of debt to determine the appropriate interest rate.

Is the arm's length amount of debt with or without a parental guarantee?

It may have been that, as a matter of practice, prior to the amendment of s 815-140 for general class investors, some taxpayers did not calculate the arm's length amount of debt in the context of s 815-140 (if they were within the safe harbour limit for thin capitalisation purposes). However, as described above, a close reading of the statute suggests that this was indeed required. As a matter of statutory construction, the taxpayer must work out the interest rate on a debt interest as if the arm's length conditions had operated, including in relation to the amount of debt, but apply that interest rate to the actual debt interest issued.

The operation of s 815-140 prior to its amendment by the thin capitalisation amendments thus depended, inter alia, on there being a difference between:

- the amount of debt that an entity might be expected to have borrowed at arm's length; and
- the amount of debt that the entity actually borrowed.

This is evident from the use of the phrase 'debt interest the entity actually issued' in s 815-140(2)(b), which is juxtaposed with working out the arm's length conditions that apply to the debt interest pursuant to s 815-140(2)(a) in each of those provisions. Put differently, without the potential for a difference between the arm's length of the borrowing and the actual amount of the borrowing, s 815-140 would be rendered otiose.[45]

By extension, if in calculating the arm's length amount of debt, the taxpayer was to impute a parental guarantee where the borrowing from the parental group would necessarily equalise the arm's length amount that could be borrowed with the amount of the actual borrowing, s 815-140 would have no operation.

It is therefore arguable that, in the context of s 815-140, a calculation of the arm's length amount would necessarily preclude the imputation of a parental guarantee. To allow otherwise would vitiate the very purpose of the provision, rendering it a legislative nullity and contravening fundamental

[45] See *Project Blue Sky Inc v Australian Broadcasting Authority* (1998) 194 CLR 355, 382 [71] (McHugh, Gummow, Kirby and Hayne JJ).

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principles of statutory interpretation. Whether this construction is correct is not a matter that has yet been ventilated in a decided transfer pricing case. This was not fully ventilated in this context in either of the *Chevron* or the *Singtel* cases. A question remains whether a consideration of the statutory construction of these provisions may have yielded a different analysis in relation to the imputation of guarantees under the transfer pricing provisions.

2.3.3 Amendment of s 815-140

From 1 July 2023, the abovementioned *concession* was effectively 'switched off' by the Treasury Laws Amendment 2024 for general class investors.[46] This means that taxpayers (who are general class investors) will need to establish that the *actual quantum of debt* is an arm's length quantum of debt or risk the Commissioner using the transfer pricing provisions to substitute the actual amount of debt with a lower, arm's length amount of debt for tax purposes.

Specifically, s 10 of Schedule 2 to the Treasury Laws Amendment 2024 states:

> 10. After paragraph 815-140(1)(a)
>
> Insert:
>
> (aa) the entity
>
> (i) is *not* a general class investor in relation to the income year; and
>
> (ii) has *not* made a choice under subsection 820-85(2C) or 820-185(2C) in relation to the income year; and

To illustrate the change, by way of example, for general class investors, if:

- an intragroup loan entailed a taxpayer borrowing $150 million of related party debt at an actual interest rate of 15% (resulting in an interest payment of $22.5 million); and
- the arm's length interest rate was found to be 10% rather than 15%; and
- the arm's length quantum of debt was found to be $100 million rather than $150 million,

then

- **Pre 1 July 2023**: the arm's length interest rate (of 10%) would be applied under s 815-140 to the actual amount of debt ($150 million), resulting in an interest deduction of $15 million. This would result in the cancellation of a transfer pricing benefit (being the difference between the actual and arm's length interest payments) of $7.5 million ($22.5 million minus $15 million).
- **Post 1 July 2023**: the arm's length interest rate would be applied to the arm's length amount of debt ($100 million), resulting in an interest deduction of $10 million. Therefore, the transfer pricing benefit cancelled under Subdivision 815-B (being the difference between the actual and arm's length interest payments) would be $12.5 million ($22.5 million minus $10 million).

As can be seen, in this example, the transfer pricing benefit that would be denied following the amendment (should the transfer pricing rules apply) is significantly higher than that under the old rules.

[46] Treasury Laws Amendment 2024 sch 2 10.

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Is the arm's length amount of debt with or without a parental guarantee?

This illustration, however, does not consider the possibility that the Commissioner, in undertaking a transfer pricing analysis, might impute a parental guarantee when determining the arm's length amount of debt. To date, the ATO is yet to issue any guidance as to how exactly the Commissioner will undertake this analysis.

Specifically, in determining the arm's length amount of debt, it remains unclear whether or how the Commissioner will factor in the potential impact of a parental guarantee, with or without a guarantee fee given the jurisprudence in *Chevron* and *Singtel*. Perhaps consistent with the statutory construction analysis put forward above in relation to the old rules, the Commissioner should not impute a parental guarantee when calculating the arm's length quantum of debt. Indeed, if the Commissioner were to do so, assuming an intragroup loan from an entity in the parental group and a guarantee from the parent entity, it would be unlikely that there would be a difference between the actual and arm's length amount of debt.

Alternatively, the ATO may contend that the arm's length amount of debt might be measured as against the amount of debt that is typically regarded as supportable within the capital structures of the specific industry, rather than as against the borrower's actual borrowing capacity. In other words, it might be that the arm's length amount of debt is calculated accounting for industry standards or typical leverage.

These questions remain unanswered and it will be for the ATO to issue guidance on this issue in the near term (and for taxpayers to consider the application of the tax law to such scenarios).

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3. Intragroup financing arrangements under the DDCR

3.1 Introduction

The Commissioner may also challenge intragroup financing arrangements under the new 'debt deduction creation rules' (the ***DDCR***), which were introduced into the ITAA 1997 by the Treasury Laws Amendment 2024.

The new DDCR, introduced in Subdivision 820-EAA of the ITAA 1997, are intended to be a modernised version of former Division 16G of the ITAA 1936.[47] Its introduction aligns with Chapter 9 of the OECD BEPS Action 4 recommendations, which recognise the need for supplementary rules to 'prevent debt deduction creation' beyond general interest limitation rules.[48] The underlying ideal is to prevent avoidance of the effect of the general thin capitalisation rules, discussed at Section 4.[49]

Broadly, the DDCR aims to disallow 'debt deductions to the extent that they are incurred in relation to debt creation schemes that lack genuine commercial justification'.[50] The rules seek to limit the deductibility of interest on intragroup debt when such debt is used to finance the acquisition from, or make certain payments to, related parties (referred to in the DDCR as 'associate pairs').[51] Specifically, the rules target related party debt by prohibiting debt deductions in the following two circumstances:

- **The acquisition case**: An entity acquires a CGT asset or legal or equitable obligation from an 'associate pair' using related party debt.
- **The payment/distribution case**: An entity funds or facilitates the funding of certain payments or distributions to an associate pair using related party debt.[52]

Concerns have been expressed regarding the broad nature of the rules, with submissions to the Senate suggesting that their practical effect 'does not give effect to [the DDCR's] stated intention',[53] and that the absence of both a purpose test and a Commissioner discretion, may serve to exclude transactions with a commercial justification.[54]

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[47] Explanatory Memorandum, Treasury Laws Amendment (Making Multinationals Pay Their Fair Share — Integrity and Transparency) Bill 2023 (Cth) (***EM to the Treasury Laws Amendment 2024***), [2.147].
[48] Ibid.
[49] OECD, BEPS Action 4 Report, 72 [171].
[50] EM to the Treasury Laws Amendment 2024, [2.146].
[51] ITAA 1997 s 820-423A(2)(e).
[52] ITAA 1997 s 820-423A.
[53] Perpetual Limited, Submission No 3 to Senate Economics Legislation Committee, Inquiry into Government Amendments to Treasury Laws Amendment (Making Multinationals Pay Their Fair Share — Integrity and Transparency) Bill 2023 (20 December 2023) 2; Corporate Tax Association, Submission No 12 to Senate Economics Legislation Committee, Inquiry into Government Amendments to Treasury Laws Amendment (Making Multinationals Pay Their Fair Share — Integrity and Transparency) Bill 2023 (22 December 2023) 2.
[54] QIC, Submission No 8 to Senate Economics Legislation Committee, Inquiry into Government Amendments to Treasury Laws Amendment (Making Multinationals Pay Their Fair Share — Integrity and Transparency) Bill 2023 (22 December 2023) 2; Property Council of Australia, Submission No 2 to Senate Economics Legislation Committee, Inquiry into Government Amendments to Treasury Laws Amendment (Making Multinationals Pay Their Fair Share — Integrity and Transparency) Bill 2023 (15 December 2023) 7; Financial Services Council, Submission No 9 to Senate Economics Legislation Committee, Inquiry into Government Amendments to Treasury Laws Amendment (Making Multinationals Pay Their Fair Share — Integrity and Transparency) Bill 2023 (December 2023) 3.

Notably, the DDCR does not include grandfathering provisions or transitional relief and awaits promised ATO guidance.[55]

3.2 The old regime: former Division 16G

Former Division 16G was inserted into ITAA 1936 in 1998. In essence, former Division 16G aimed to disallow interest deductions on debt used to fund asset transfers between related entities where both entities were at least 50% controlled by a non-resident or by related non-residents, subject to specific exceptions.

Despite the DDCR being described as a new version of former Division 16G, there are several significant differences, including:

- whereas former Division 16G only applied to debt creation schemes involving non-residents, the DDCR can apply to a wholly domestic transaction involving two related Australian residents;
- whereas former Division 16G applied only to the acquisition of assets using related party debt, the DDCR applies also to the acquisition of a legal or equitable obligation as well as to the distribution of payments to an associated pair;
- whereas former Division 16G applied to companies to the exclusion of other entities such as partnerships or trusts, the DDCR is not so limited; and
- whereas former Division 16G conferred upon the Commissioner a discretion such that if the Commissioner is satisfied that the acquisition has not and will not result directly or indirectly in an increase in the overall indebtedness of the group, the associated deduction would not be reduced, the DDCR does not confer a similar discretion.

Division 16G was repealed in 2001 at the same time that the then-new thin capitalisation regime was introduced to combat excessive debt pushdown into Australia by large MNEs.[56]

3.3 The legislative framework

3.3.1 No grandfathering provisions or transitional relief

The DDCR was effective from 1 July 2024.[57] It does not include any grandfathering provisions or transitional relief.

3.3.2 Who is subject to the DDCR?

The DDCR rules apply to an entity that is either:

[55] Evidence to Economics Legislation Committee, Parliament of Australia, Canberra, 31 January 2024, 18 (Ben Kelly, Deputy Commissioner of the Australia Taxation Office).
[56] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), 3.
[57] Treasury Laws Amendment (Making Multinationals Pay Their Fair Share — Integrity and Transparency) Act 2024 (Cth) s 144(3) (***Treasury Laws Amendment 2024***).

- a general class investor;[58]
- an outward investing financial entity (non-ADI); or
- an inward investing financial entity (non-ADI).[59]

3.3.3 Exclusions from the DDCR

The DDCR will not apply to an entity should any of the following apply:

- the entity is a 'securitisation vehicle';[60]
- the entity is an ADI (that is, a company that is authorised to carry on a banking business in Australia for the purposes of the *Banking Act 1959* (Cth));[61]
- the entity has total debt deductions for the income year of $2 million or less;[62]
- the entity qualifies for an exemption as a 'special purpose entity';[63]
- the entity is a qualifying 'Australian plantation forestry entity';[64] or
- the entity chooses the 'third party debt test' under the thin capitalisation rules (see Section 4.4 below).[65]

As canvassed above, the DDCR does not include an exception for wholly domestic debt arrangements.[66]

The DDCR provisions are self-executing.

3.3.4 The acquisition case

As mentioned above, the acquisition case essentially applies when an entity, using related party debt, acquires a CGT asset or a legal or equitable obligation from an associate pair. Per s 995-1 of the ITAA 1997, an entity (Entity A) is an 'associate pair' of another entity (Entity B) where Entity A is an 'associate' of Entity B, or where Entity B is an 'associate' of Entity A. 'Associate' is defined under s 318 of the ITAA 1936.

The specific requirements to make out the acquisition case are as follows:

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[58] 'General class investor' is defined in s 820-46 of the ITAA 1997.
[59] ITAA 1997, s 820-423A(1).
[60] ITAA 1997 s 820-423A(1)(aa). 'Securitisation vehicle' is defined at s 820-942(2).
[61] ITAA 1997 s 820-423A. ADIs are not listed, effectively exempting them from the application of the DDCR.
[62] ITAA 1997 s 820-35.
[63] ITAA 1997 s 820-39.
[64] Treasury Laws Amendment 2024, s 146.
[65] ITAA 1997, ss 820-423A(2)(g), 820-423A(5)(f). This test is discussed below in Section 4.4 below.
[66] In its submission to the Senate Economics Legislative Committee, QIC recommended that 'purely domestic arrangements should not be covered by the rules at all as any debt creation would be expected to give rise to corresponding assessable income for the lender as well as a deduction available to the borrower: QIC, Submission No 8 to Senate Economics Legislation Committee, *Inquiry into Government Amendments to Treasury Laws Amendment (Making Multinationals Pay Their Fair Share — Integrity and Transparency) Bill 2023* (22 December 2023) 2.

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- an entity (the ***acquirer***) acquires a CGT asset, or a legal or equitable obligation, either directly or indirectly from one or more other entities (each, a ***disposer***);
- one of more of the disposers is an associate pair of the acquirer (the ***associate disposer***);
- the entity claiming the debt deductions (the ***relevant entity***) is either the acquirer, an associate pair of the acquirer, or an associate pair of an associate disposer;
- the relevant entity's debt deduction relates, wholly or partly, to the acquisition, or to the acquirer's holding of the CGT asset, or the legal or equitable obligation; and
- the debt deduction is referrable to an amount paid to or payable, directly or indirectly, to an associate pair of the relevant entity, an associate pair of the acquirer or an associate pair of an associate disposer.[67]

The following are other matters to note about the acquisition case:

- The term 'legal or equitable obligation' is not defined in the legislation. It is not immediately clear what the term is intended to cover.
- It is unclear at what stage of the process a disposer must be an 'associate pair' of the acquirer; specifically, whether it is at the time of the relevant acquisition, at the time of the specific debt deduction, or at some other time.
- A nexus must exist between the debt deductions incurred and the acquisition of the CGT asset (or legal or equitable obligation), or the holding of such asset or obligation.[68]
- The acquisition of the following CGT assets are excluded:
  - new membership interests in an Australian entity or a foreign company;[69]
  - certain new depreciating assets (but not intangible assets);[70] and
  - certain debt interests.[71]
- There is no exclusion for the acquisition of trading stock (unlike under former Division 16G).[72]

3.3.5 The payment/distribution case

The payment/distribution case applies when:

- an entity (the ***payer***) enters into or has a 'financial arrangement' with another entity;
- the payer uses the financial arrangement to fund, or facilitate the funding of, one or more payments or distributions that to an extent is made to an associate pair of the payer (an ***associate recipient***);

[67] ITAA 1997, s 820-423A(2)–(4).
[68] ITAA 1997 s 820-423A(2)(e).
[69] ITAA 1997 s 820-423AA(1).
[70] ITAA 1997 s 820-423AA(2).
[71] ITAA 1997 s 820-423AA(3).
[72] ITAA 1936 former s 159GZZF(2).

- the payment or distribution is of the kind that is covered by the provisions;
- the entity claiming the debt deductions (the ***relevant entity***) is either the payer, an associate pair of the payer, or an associate pair of an associate recipient;
- the relevant entity's debt deduction relates, wholly or partly, to the abovementioned financial arrangement; and
- the debt deduction is referrable to an amount paid to or payable, directly or indirectly, to an associate pair of the relevant entity, an associate pair of the payer or an associate pair of an associate recipient.[73]

The types of payments and distributions that will be caught by the DDCR are:

- a dividend, distribution, non-share distribution or return of capital;
- a payment or distribution to cancel or redeem a membership interest in an entity;
- a royalty, or similar payment or distribution for the use, or right to use, an asset;
- a payment or distribution that is referable to the repayment of principal under a debt interest issued by the payer which itself was, broadly, used to fund or facilitate the funding of a prescribed payment or distribution;
- a payment or distribution of a 'kind similar' to the above; and
- a payment or distribution prescribed by the regulations (however, no such payment or distribution is currently prescribed).[74]

Other matters to note about the payment/distribution case are:

- For the payer to 'facilitate the funding' of a payment or distribution, there must be a direct or indirect connection between the use of the financial arrangement and the funding of the payment or distribution.[75]
- The entity claiming the deductions may be an entity other than the payer itself, such as the parent of the payer.
- A nexus must exist between the debt deductions incurred and the financial arrangement which funds, or facilitates the funding of, the relevant payment or distribution.[76]

3.3.6 Quantum of debt deductions disallowed

For the acquisition case, debt deductions are disallowed *to the extent that* the debt deduction was incurred on the acquisition or holding of the relevant CGT asset or legal or equitable obligation.[77]

[73] ITAA 1997, ss 820-423A(5)–(7).
[74] See ITAA 1997, s 820-423A(5A) for the list of the types and distributions caught by the rule.
[75] ITAA 1997 s 820-432A(7).
[76] ITAA 1997 s 820-423A(5)(d).
[77] ITAA 1997 s 820-423A(1).

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For the payment/distribution case, debt deductions are disallowed proportionately to the extent to which the financial arrangement funds or facilitates the funding of the relevant payment or distribution.[78]

3.3.7 The anti-avoidance rule

Section 820-423D introduces a specific anti-avoidance rule for the DDCR. Where the Commissioner is satisfied that a scheme was entered into for the principal purpose of ensuring no debt deductions are denied under the DCCR, he may apply the DDCR despite the scheme being permitted by the rules.

Helpfully for taxpayers, Treasury has confirmed that while the anti-avoidance rule is designed to target 'schemes that seek to exploit the related party debt condition to artificially locate or "debt dump" third party debt in Australia'; it is not intended to apply to schemes where an entity is legitimately restructuring out of an arrangement that would otherwise be caught by the DDCR.[79]

Interestingly, as with the DPT rules, s 820-423D operates at a lower threshold than the GAAR, requiring a 'principal purpose' rather than a 'sole or dominant purpose' (see Section 5 below).

On 9 October 2024, the ATO published draft practice compliance guideline (***PCG***) 2024/D3 designed to provide guidance on the application of the DDCR anti-avoidance rule.[80] Specifically, the draft guidance 'sets out [the ATO's] compliance approach to restructures [in response to the DDCR] by providing a risk assessment framework'.[81] The draft guidance is open for public comment until 8 November 2024.

3.3.8 Tracing and apportionment

In draft PCG 2024/D3, the ATO provide guidance in relation on the methodologies to trace and apportion the disallowance of debt deductions under subsection 820-423A(1).

In relation to tracing, the ATO considers it to be a 'factual exercise' and that it 'should be used to determine the disallowed debt deduction … wherever possible'.[82]

Crucially, the draft guidance outlines that apportionment 'does not replace tracing'.[83] However, apportionment 'may be appropriate where it is not possible to trace, such as where funds from various sources that were used for different purposes are combined into a single debt interest'.[84] Practically, 'whether an apportionment methodology is appropriate will depend on whether it is fair and reasonable in the relevant facts and circumstances'.[85]

[78] ITAA 1997 s 820-423A(1).
[79] Supplementary Explanatory Memorandum, Treasury Laws Amendment (Making Multinationals Pay Their Fair Share — Integrity and Transparency) Bill 2023 (Cth), [1.43] (***Supplementary EM to the Treasury Laws Amendment 2024***).
[80] Draft PCG 2024/D3.
[81] Ibid [46].
[82] Ibid [152].
[83] Ibid [153].
[84] Ibid.
[85] Ibid [154]. At [155], the draft guidance provides a factual circumstance where apportionment would be fair and reasonable.

In essence, an apportionment exercise must be based on the facts and circumstances of the individual taxpayer's affairs, and any methodology that is not so based will not be considered fair and reasonable.[86]

3.4 Application to previously decided cases

In order demonstrate how the DDCR regime provides the Commissioner with a new tool with which to tackle intercompany financial arrangements, the ATO identified six examples of decided cases that may have been covered by the DDCR had it existed at the time. Of the six cases, the ATO was successful in five (three under substantive taxation rules and two under Part IVA).

The Treasury view in support of the DDCR was that it was necessary so that the ATO did not need to undertake resource intensive challenges to certain funding structures under Part IVA.

The following cases were identified by the ATO:

- *Singtel* — A foreign entity loaned funds to its Australian subsidiary, that used the funds to partially finance the acquisition of shares in a related party owned by the lender (i.e. vendor finance). The ATO succeeded in a transfer pricing claim, with the Federal Court disallowing substantial interest deductions claimed by the taxpayer.
- *News Australia Holdings Pty Ltd v FCT*[87] — A holding company obtained a loan from its foreign-based subsidiary to acquire equity in that same subsidiary entity. The ATO succeeded in its claim as to when interest was assessable.
- *Chevron* — An Australian resident company borrowed funds from a foreign related party to refinance existing Australian dollar denominated debt. The pre-existing debt was related party debt and was originally incurred to fund both a return of capital and the acquisition of another business. The ATO succeeded on transfer pricing grounds, with the decision upheld on appeal.
- *Orica Limited v Commissioner of Taxation*[88] — This involved a complex 'loan-up' scheme wherein related party debt was used to fund payments to an offshore related party which in turn provided those funds back to other Australian members of the group. The initial related party loan was used by the borrower to repay existing debts and to subscribe for redeemable preferences securities in a foreign resident subsidiary, which then loaned the funds back to the Australian lender per the initial agreement. Under Part IVA, the court found that the series of transactions created a 'tax benefit' thereby denying the debt deductions.
- *Commissioner of Taxation v Consolidated Press Holdings*[89] — A loan was secured from a related party to acquire shares in an associate that was interposed between the borrowing company and another company which generated no foreign-sourced income. The High Court found in favour of the Commissioner on Part IVA grounds.

[86] Draft PCG 2024/D3, [156]–[157].
[87] (2017) 105 ATR 874.
[88] (2015) 332 ALR 621.
[89] (2001) 207 CLR 235.

- *Federal Commissioner of Taxation v Total Holdings (Australia) Pty Ltd*[90] — Funds were borrowed from a parent company to extend non-interest-bearing loans to an associated entity. The Full Federal Court found in favour of the taxpayer, allowing the deductions.

The ATO presumably would contend that in each case there were debt deductions referable to intragroup borrowing used to fund the acquisition of a CGT asset from, or fund a relevant payment or distribution to, an associated entity that would have resulted in the denial of a deduction under the DDCR, had it applied. It is beyond the scope of this paper to analyse the six cases identified by the ATO in that respect.

Mylan was decided following the parliamentary discussion on these issues. A question also arises as to whether *Mylan* represents a factual scenario where despite the Commissioner being unsuccessful in his Part IVA case, he might have been successful under the DDCR had it applied at the relevant time.

3.5 Observations

The DDCR's broad scope and automatic (and in some respects retrospective) application create new layers of complexity for multinational groups.

Additionally, there remain several areas in which the ATO needs to provide further guidance, some of which include:

- the interaction between the DDCR and other regimes; and
- the meaning of 'facilitate the funding' in the payment/distribution case.

The DDCR represents a significant expansion of Australia's international taxation integrity measures.

[90] (1979) 43 FLR 217.

4. Intragroup financing arrangements under the (new) thin capitalisation regime

4.1 Introduction

Interest deductions for intragroup debt can also be denied under the new thin capitalisation or interest limitation regime.

For income years commencing on or after 1 July 2023, general class investors[91] (being entities other than ADIs and financial entities, that are subject to the thin capitalisation rules) will be required to choose, for each income year, which of the three new tests they are eligible to and will apply:

- **Fixed Ratio Test:** This test allows entities to claim net debt deductions up to 30% of Tax EBITDA.
- **Group Ratio Test:** This allows entities to claim net debt deductions up to the ratio of the worldwide group's net interest expense to EBITDA, with certain adjustments; or
- **Third Party Debt Test:** Debt deductions not attributable to third party debt, or which do not satisfy certain additional safeguard rules, are disallowed.

If no choice is made before the deadline for or date of lodgement of the tax return for that income year the new fixed ratio test will automatically be applied.

The new provisions were introduced by the Treasury Laws Amendment 2024 (along with the new Debt Deduction Creation Rule and transfer pricing modification provisions discussed above).

This discussion focusses on the rules applying to general class investors, not those applying to ADIs or financial entities (non-ADIs). Also, as the paper relates to intragroup financing, the third party debt test is only briefly discussed.

The most significant change is a shift from an asset-based thin capitalisation safe harbour ratio to an earnings-based ratio, which is expected to be the primary test for most entities subject to the thin capitalisation rules. This is at the recommendation of the OECD, which described an earnings-based ratio as being more robust than an asset-based ratio for thin capitalisation purposes:[92]

> 73. … a goal of the BEPS project is to address practices that artificially separate taxable income from the activities that generate it. For most entities it is expected that there should be a clear correlation between earnings and taxable income. Therefore, measuring economic activity using earnings should be the most effective way to ensure that the ability to deduct net interest expense is matched with the activities that generate taxable income and drive value creation.

[91] The new thin capitalisation regime applies primarily to general class investors (being entities, other than ADIs and financial entities, that are subject to the thin capitalisation rules (which, broadly speaking, means that they are an inward or outward investor with the requisite level of foreign ownership or investment)). General class investors may use any of the three new tests. Financial entities (being entities, other than ADIs, that are licensed securities dealers, licensed derivatives dealers or securitisation vehicles) may continue to use the asset-based safe harbour debt test or the worldwide gearing test, or may choose to use the new third party debt test. ADIs and Australian plantation forest entities will continue to apply the existing tests within the thin capitalisation regime.

[92] OECD, BEPS Action 4 Report, 47 [73]–[74].

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> 74. Another benefit of an earnings-based approach is that it makes a general interest limitation rule more robust against planning. Where the level of deductible interest expense in an entity is linked to earnings, a group can only increase net interest deductions in a particular country by increasing earnings in that country. Similarly, any restructuring to move profits out of a country will also reduce net interest deductions in the country.

The new regime is intended to align Australia's domestic law with the 'best practice approach' recommended by the OECD in its BEPS Action 4 report, being:

- an optional *de minimis* monetary threshold to remove low risk entities;
- a fixed ratio rule allowing an entity to deduct net interest expense up to a benchmark net-interest-to-EBITDA ratio, with the particular ratio set by the country;
- a group ratio rule allowing an entity to deduct net interest expense up to its group's net-interest-to-EBITDA ratio, where this is higher than the benchmark fixed ratio;
- an optional carrying forward of disallowed interest and/or unused interest capacity, and/or carrying back of disallowed interest;
- targeted rules to support general interest limitation rules and address specific risks; and
- specific rules to address issues raised by the banking and insurance sectors.[93]

4.2 The fixed ratio test

The fixed ratio test replaces the existing safe harbour debt test for general class investors, allowing an entity to claim net debt deductions up to 30% of its 'Tax EBITDA'.

4.2.1 Tax EBITDA

An entity's ***Tax EBITDA*** is, at a high level, an entity's taxable income or tax loss to which is added back the entity's net debt deductions and certain other deductions such as those for amortised depreciation and building allowances, and assuming all prior year tax losses are utilised. For the purpose of calculating the taxable income or tax loss of the entity, franking credits included in assessable income and dividends paid to the entity by an associate entity are disregarded. This is provided for in s 820-52 (omitting subsection (4) and following) as follows:

> (1) An entity's tax EBITDA for an income year is worked out as follows:
>
> (a) first, work out the entity's taxable income or tax loss for the income year (disregarding the operation of this Division (other than Subdivision 820-EAA) and treating a tax loss as a negative amount);
>
> (b) next, add the entity's net debt deductions for the income year;
>
> (c) next, add the sum of the entity's deductions (if any) from its assessable income for the income year that are any of the following:

[93] OECD, BEPS Action 4 Report, 25 [22] (Figure 1.1).

(i) general deductions that relate to forestry establishment and preparation costs unless those costs relate to the clearing of native forests;

(ii) deductions under Divisions 40 and 43 (other than deductions for the entire amount of an expense incurred by the entity);

(iii) deductions under section 70-120;

(ca) next, if the entity is an entity to which subsection 820-60(1) applies — add the excess tax EBITDA amount (if any) worked out under that section for the income year;

(d) next, make adjustments to the result of paragraph (c) or (ca), as the case requires, in accordance with regulations (if any) made for the purposes of this paragraph.

If the result of paragraph (d) is less than zero, treat it as being zero.

Note: The entity's net debt deductions for the income year can be a negative amount.

(1A) In working out the taxable income or tax loss of a corporate tax entity for an income year for the purposes of subsection (1), assume that:

(a) the entity chooses to deduct, under subsection 36-17(2) or (3), all of the entity's tax losses for *loss years occurring before the income year; and

(b) subsection 36-17(5) does not apply to that choice.

(2) For the purposes of this section, disregard Division 207, to the extent that Division results in an amount of, or a share of, a franking credit being included in the entity's assessable income for the income year.

(3) In working out the taxable income or tax loss of an entity for the purposes of subsection (1), disregard any dividend or non-share dividend paid to the entity by an associate entity and included in the entity's assessable income under section 44 of the *Income Tax Assessment Act 1936*.

Dividends assessable under s 44 of the ITAA 1936 are disregarded for Tax EBITDA purposes where the dividend is paid by an associate entity,[94] to ensure that EBITDA capacity is not able to be duplicated between associate entities.[95]

Broadly, shares in the net income of trusts or partnerships will be excluded from the Tax EBITDA calculation where the entity is an associate entity. It is intended that such amounts would count towards the Tax EBITDA of the relevant partnerships and trusts, and not of the entities which are ultimately assessed on those amounts (i.e. the partners, beneficiaries and trustees).[96]

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[94] ITAA 1997 s 820-52(3).
[95] Senate Economics Committee Report (22 September 2023) [1.73]–[1.81].
[96] EM to the Treasury Laws Amendment 2024, [2.69].

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4.2.2 Carrying forward of denied debt deductions

Debt deductions denied under the fixed ratio test may be carried forward over a 15 year period.[97] Similarly to other carried-forward tax losses, the ability for an entity to carry forward these amounts is predicated on the following conditions:

- for a company, satisfying a modified continuity of ownership test or business continuity test; and
- for a trust, satisfying a modified version of the trust loss rules in Schedule 2F to the ITAA 1936.[98]

The special deduction rule allows entities to claim deductions that have been previously been disallowed within the past fifteen years under the fixed ratio test (subject to the above conditions) in a later income year when they are sufficiently profitable and where their fixed ratio earnings limit exceeds their net debt deductions.

The special deduction rule is particularly relevant to entities with significant upfront expenditure, or to entities which may not generate taxable income for some years.

For an entity that originally elected to use the fixed ratio rule and later elects to use the group ratio test or the third party debt test, the benefit of those accrued disallowed deductions will be lost.[99]

4.3 The group ratio test

The amendments also introduced a group ratio test which replaced the worldwide gearing test. The group ratio test also may allow general class investors to deduct more 'net debt deductions' than is permitted under the fixed ratio rule, based on a ratio which incorporates a group's worldwide interest expense. The test will be relevant for highly leveraged groups.

The standard test for a general class investor to apply is the fixed ratio test discussed at Section 4.2 above. However, an entity that is a general class investor may choose to use the group ratio test if certain requirements are made out. Such a choice must be made in the approved form.[100] Note that once an election has been made to use the group ratio test for an income year, it is generally irrevocable for that income year (subject to some limited exceptions).[101]

The group ratio test uses the concept of 'GR group', which has two similar but distinct definitions.

- If audited consolidated financial statements have been prepared for a worldwide parent entity (being an entity which is not controlled by another entity),[102] the ***GR group*** is constituted of that worldwide parent entity (the ***GR group parent***) and each other entity that is fully consolidated on a line-by-line basis in those audited consolidated financial statements (each, a ***GR group member***).[103]
- If the above does not apply and if global financial statements (as opposed to audited consolidated financial statements) have been prepared for a global parent entity (being an entity that,

[97] ITAA 1997 s 820-56.
[98] ITAA 1997 s 820-59
[99] ITAA 1997 s 820-58.
[100] ITAA 1997 s 820-47(1).
[101] ITAA 1997 s 820-47(3).
[102] ITAA 1997 s 820-936(6).
[103] ITAA 1997 s 820-53(2)(a).

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according to accounting principles, is not controlled by another entity)[104], the ***GR group*** is constituted of that global parent entity (the ***GR group parent***) and each other entity that is fully consolidated on a line-by-line basis in those global financial statements (each, a ***GR group member***).[105]

An entity may choose to use the group ratio test if the entity is a GR group member of a GR group and the GR group EBITDA is greater than zero.[106]

GR group EBITDA is the sum of the following amounts as disclosed in the audited consolidated financial statements or the global financial statements for the GR group parent (as applicable):

- the GR group's net profit (disregarding tax expenses);
- the GR group's adjusted net third party interest expense; and
- the GR group's depreciation and amortisation expenses.

GR group net third party interest expense is the amount disclosed as such in the audited consolidated financial statements or the global financial statements for the GR group parent (as applicable) reduced by the amount of each payment (if any) by a GR group member to an associate entity who is not a GR group member, to the extent that it was a factor in working out that 'net third party interest expense',[107] with 'interest' including any amount in the nature of interest or economically equivalent to interest.[108] If the statements do not disclose 'net third party interest expenses' specifically, the legislation provides a formula for calculation.[109]

Finally, an entity's ***group ratio*** is calculated as follows:[110]

$$group\ ratio = \frac{GR\ group\ net\ third\ party\ interest\ expense}{GR\ group\ EBITDA}$$

If the result is less than zero, the entity's group ratio is zero.

Under the group ratio test, an entity's ***group ratio earnings limit*** is calculated as follows:

$$group\ ratio\ earnings\ limit\ = group\ ratio\ \times tax\ EBITDA$$

For an entity that has elected to apply the group ratio test, to the extent an entity's net debt deductions exceed the entity's group ratio earnings limit, that amount of debt deductions will be disallowed.[111]

The ATO recognises the need to provide guidance on applying the group ratio test, specifically regarding the calculation of the 'group ratio' and identifying relevant financial statements. However, as of the date of this paper, no such guidance has been released.

[104] ITAA 1997 s 960-560.
[105] ITAA 1997 s 820-53(2)(b).
[106] ITAA 1997 s 820-46(3).
[107] ITAA 1997 s 820-54(2)(a).
[108] ITAA 1997 s 820-54(1).
[109] ITAA 1997 s 820-54(2)(b).
[110] ITAA 1997 s 820-53(1).
[111] ITAA 1997 s 820-50(2).

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4.4 The third party debt test

The new thin capitalisation rules also introduced the 'third party debt test' for general class investors and financial entities (however, ADIs will continue to be able to access the existing arm's length capital test).

Under the third party debt test, debt deductions (rather than net det deductions) of an entity which are not attributable to third party debt are disallowed. That is, only debt deductions attributable to debt interests that satisfy the 'third party debt conditions' will be allowed. This test would therefore most likely be suitable for taxpayers that use third party, rather than related party, debt.

As with the group ratio test, a general class investor may choose to use the third party debt test if certain requirements are made out. A financial entity may also elect to use the third party debt test in lieu of the safe harbour debt test or the worldwide gearing test of the old thin capitalisation regime.

A choice to use the third party debt test must be made in the approved form.[112] Note that once an election has been made to use the third party debt test for an income year, it is generally irrevocable for that income year (subject to some limited exceptions).[113] An entity may also be deemed to have made the choice to use the third party debt test if it is a member of an obligor group (as defined below) in relation to a debt instrument where another member of that obligor group who is an associate entity has chosen to use the third party debt test.[114]

For an entity who has elected to apply the third party debt test, to the extent the entity's debt deductions exceed the entity's 'third party earnings limit' for the income year, that amount of debt deductions will be disallowed.[115] An entity's ***third party earnings limit*** refers to the sum of each debt deduction of the entity that is attributable to a debt interest issued by the entity that satisfies the 'third party debt conditions'.[116]

The third party debt conditions are as follows:

- the entity (the ***borrower***) issued the debt interest to an entity that is not an associate entity,[117] and the debt interest is not held at any time by an associate entity;[118]
- the holder of the debt interest (the ***creditor***) has recourse for payment of the debt interest only to Australian assets which:[119]
    - are held by the borrower;[120]
    - are membership interests in the borrower (unless the borrower has an interest in an asset which is not an Australian asset);[121] or

[112] ITAA 1997 s 820-47(1).
[113] ITAA 1997 s 820-47(3).
[114] ITAA 1997 s 820-48(1).
[115] ITAA 1997 s 820-50(1)(c).
[116] ITAA 1997 s 820-427A(1).
[117] ITAA 1997 s 820-427A(3)(a).
[118] ITAA 1997 s 820-427A(3)(b).
[119] ITAA 1997 s 820-427A(3)(c).
[120] ITAA 1997 s 820-427A(4)(a).
[121] ITAA 1997 s 820-427A(4)(b).

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- are held by an Australian entity that is a member of the same obligor group as the borrower (i.e. is another entity to which the creditor has recourse for payment)[122] in relation to that debt interest;[123]

- the borrower uses all, or substantially all, of the debt to fund its commercial activities in connection with Australia;[124] and
- the borrower is an Australian entity.[125]

Unlike for the fixed ratio test, there is no ability for disallowed deductions to be carried forward or shared with controlling entities.

There is an express prohibition on the lender having recourse to any rights under or in relation to a guarantee, security or other form of credit support.[126] The rationale for this exclusion is to ensure that MNEs are not able to highly leverage their Australian operations (relative to their operations elsewhere) by providing credit support and 'debt dumping' in Australia.[127]

[122] ITAA 1997 s 820-49.
[123] ITAA 1997 s 820-427A(4)(c).
[124] ITAA 1997 s 820-427A(3)(d). Note the express exclusions at ss 820-427A(3)(d)(i), (ii).
[125] ITAA 1997 s 820-427A(3)(e).
[126] ITAA 1997 s 820-427A(5).
[127] EM to the Treasury Laws Amendment 2024, [2.99]–[2.101]. See also Supplementary EM to Treasury Laws Amendment 2024, [1.31].

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5. Challenges to intragroup financing arrangements under Part IVA

5.1 Introduction

The Commissioner, after having, for a time, run fewer Part IVA cases, has increased his activity in this area. He has notably done so in the context of utilising Part IVA as an alternative ground for challenging taxpayer structures that might previously have been principally (or solely) challenged under the transfer pricing provisions.

In *Glencore*, Thawley J, in discussing the Commissioner's transfer pricing case stated:

> [t]he Commissioner approached the principal issue in this case on the basis that independent parties, in the position of CMPL and GIAG, dealing with each other at arm's length, would not reasonably be expected to have agreed to a consideration for the supply of copper concentrate on the basis in fact agreed on 2 February 2007, because independent parties dealing at arm's length would not have altered their existing agreement. Whilst facts relevant to this argument might also be relevant to the issues under Div 13, this did not correctly frame the issue under Div 13. The argument hints at a case under Pt IVA of the ITAA 1936, but no such case was made. Whilst Pt IVA and Div 13 were introduced at a similar time, Div 13 does not require an investigation or consideration of purpose or motive.[128]

The decision in *Glencore* demonstrates that the Commissioner may not succeed in a transfer pricing case which focuses on the taxpayer's decision to change an existing arrangement to a less profitable one, if the taxpayer can demonstrate that the new arrangement is nevertheless one that independent parties dealing independently with each other might have been expected to have entered into, and the resultant pricing falls within an arm's length range of outcomes. Such arguments that might be seen to be based on "purpose" are the preserve of Part IVA, not Subdivision 815-B. The result in *Glencore* may have influenced the Commissioner to resort more frequently to Part IVA in cases that he might only have otherwise challenged under the transfer pricing provisions.

Further, if the exceptions to the basic rule in s 815-130(1) do not apply, so that the identification of the arm's length conditions for transfer pricing purposes must be based on the commercial or financial relations in connection with which the actual conditions operate and have regard to the form and substance of those relations, the Commissioner's ability to "reconstruct" a transaction is arguably more limited under Subdivision 815-B than under Part IVA.[129]

In *Mylan*, the Commissioner disallowed deductions for interest expenses under an intercompany promissory note (and consequential carried forward losses) utilising both the transfer pricing provisions and Part IVA. The Commissioner ultimately withdrew the transfer pricing challenge, with the case proceeding to a decision before Button J in the Federal Court only on the Part IVA ground.

Nevertheless, the case demonstrates that structures that the Commissioner might challenge under the transfer pricing provisions might also be susceptible to challenge under Part IVA. Both sets of provisions potentially taxing the taxpayer on a hypothetical transaction which is different to the actual

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[128] Glencore, 452 [272].
[129] The tests in s 815-130(3) are 'would' and 'would not' tests, meaning their application may be more difficult for the Commissioner.

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transaction entered into, but with different tests enabling the Commissioner to do so under each set of provisions.

Under Part IVA, the Commissioner can make a determination to cancel a tax benefit if the Part applies to a 'scheme' because it would be concluded, having regard to certain objective matters, that the person, or one of the persons, who entered into or carried out the scheme or part of the scheme did so for the dominant purpose of enabling a taxpayer to obtain a tax benefit in connection with the scheme.

5.2 'Scheme'

A 'scheme' is defined broadly in s 177A to include agreements, arrangements, understandings, promises or undertakings.

5.3 'Tax benefit' (in contrast to 'transfer pricing benefit')

In Subdivision 815-B (transfer pricing), the concept of a hypothetical is established through introducing the concept of a 'transfer pricing benefit' in s 815-120. A transfer pricing benefit is determined by reference to the difference in the tax outcomes between the actual and the arm's length conditions.

Under the GAAR, the tax benefit is identified by reference to the difference between the tax outcomes under the scheme as implemented and those that would have or might reasonably be expected to have occurred if the scheme had not been entered into or carried out (s 177C).

For example, in relation to assessable income and allowable deductions, s 177C(1) states:

> (1) Subject to this section, a reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as a reference to:
>
> (a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or
>
> (b) a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out; or

As a result of amendments in 2013,[130] s 177CB was introduced to bifurcate the compendious expression in s 177C in that a particular tax effect or consequence 'would … or might reasonably be expected to have … occurred' into two scenarios:

- an **annihilation** scenario in s 177CB(2), whereby a decision that a tax effect would have occurred if the scheme had not been entered into or carried out must be based on a postulate that comprises only the events or circumstances that actually happened or existed, other than those that form part of the scheme; and

[130] *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* (Cth).

- a **reconstruction** scenario in s 177CB(3) and (4), whereby a decision that a tax effect might reasonably be expected to have occurred if the scheme had not been entered into must be based on a postulate that is a reasonable alternative to the scheme. In determining whether a postulate is a reasonable alternative particular regard must be had to the substance of the scheme and the non-tax consequences for the taxpayer that are or would be achieved by the scheme, and disregarding any domestic tax effects that would be achieved by the postulate for any person.

In broad terms, while the Subdivision 815-B hypothetical 'corrects' for the non-arm's length dealing, the hypotheticals under the GAAR 'correct' for what is purported to be the tax driven scheme.

5.4 'Dominant purpose'

A key difference between the transfer pricing provisions and the GAAR in Part IVA, is the existence of a 'purpose' requirement in Part IVA and the lack of a 'purpose' requirement under the transfer pricing rules. The difference between the definitions of transfer pricing benefit and tax benefit, and the difference as to a purpose requirement, are deliberate policy design features as between the two sets of provisions.[131]

For the GAAR to apply, it must be established that a person who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling a taxpayer or taxpayers to obtain a tax benefit in connection with the scheme.[132] The purpose must be the *sole or dominant purpose*.[133] In other words, it must be the 'most influential, and prevailing or ruling purpose'.[134]

Section 177D(2) lists eight factors relevant to the analysis of objective purpose:

(a) the manner in which the scheme was entered into or carried out;

(b) the form and substance of the scheme;

(c) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;

(d) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;

(e) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;

(f) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;

---

[131] Whereas purpose sits at the centre of the GAAR, it is not a requirement in transfer pricing, thin capitalisation or the DDCR. Indeed, in Glencore (at 452 [272]), Thawley J said of former Division 13: 'Whilst Pt IVA and Div 13 were introduced at a similar time, Div 13 does not require an investigation or consideration of purpose or motive.' Put differently, perhaps, the substantive taxation rules (transfer pricing, thin capitalisation and the DDCR) are each designed to combat a specific tax consequence, notwithstanding the purpose or intent of the taxpayer. Whereas, the GAAR, as a last resort, acts to penalise a taxpayer for hatching a scheme designed to achieve a tax benefit, even where no other taxation principle is breached.

[132] ITAA 1936 s 177D(1).

[133] ITAA 1936 s 177A(5); *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404, 416 (***Spotless***).

[134] Spotless 422.

(g) any other consequence for the relevant taxpayer, or for any person referred to in paragraph (f), of the scheme having been entered into or carried out;

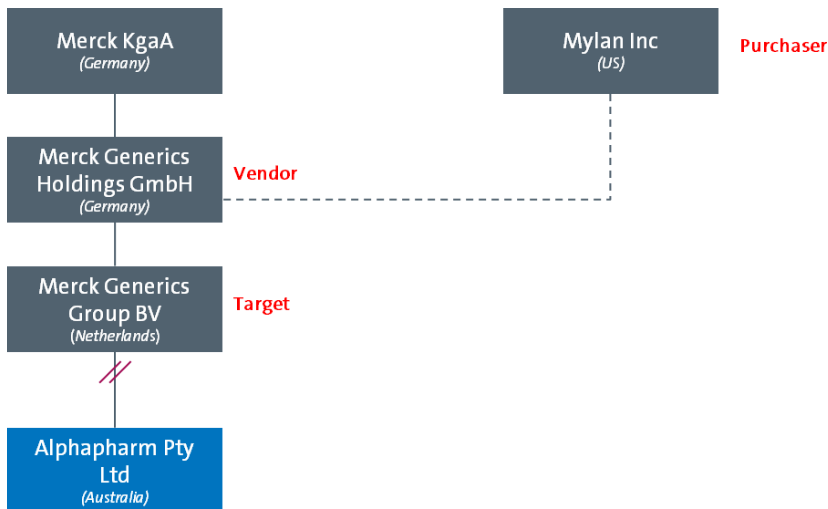
(h) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in paragraph (f).

5.5 Case study: *Mylan*

In *Mylan*, the Commissioner identified a primary, a secondary and a tertiary counterfactual to establish a tax benefit under Part IVA. An abbreviated and somewhat simplified version of the facts is set out below.

Mylan, a US company, entered into a Share Purchase Agreement (***SPA***) with Merck KGaA, a German global chemical and pharmaceutical company, and Merck Generics Holding GmbH, to purchase all of the shares in certain companies owning the Merck Generics business, which business operated in various parts of the world. This occurred on 12 May 2007.

Share Purchase Agreement:



Alphapharm Pty Ltd was Merck's indirectly held subsidiary in Australia. It was owned by Merck Generics Group BV (***MGGBV***), a Netherlands entity.

Although the SPA provided for the sale of shares in MGGBV and certain other companies, it included a clause providing that, at the election of Mylan, affiliates of Mylan, could be substituted as the purchaser to acquire interests in any Merck Generics subsidiary.

In August to September 2007, Mylan incorporated an Australian subsidiary, MAHPL, which was formed into a tax consolidated group with its subsidiary, MAPL. At the time of the acquisition, the shares in MAHPL were held by Mylan Bermuda.

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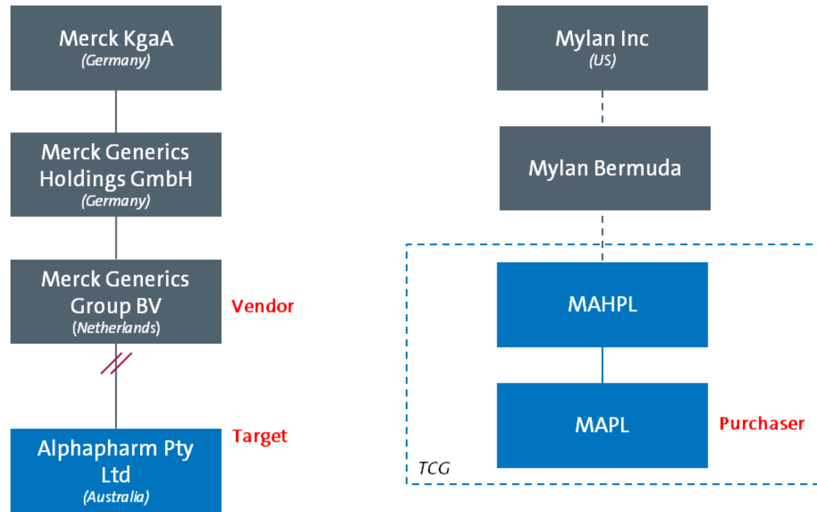
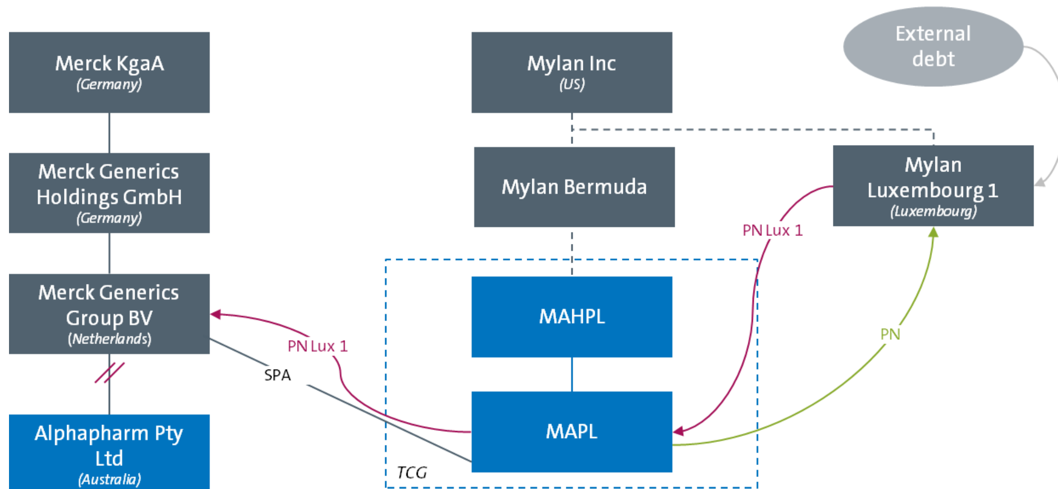
Establishment of MAHPL & MAPL:



In September to October 2007, Mylan entered into a Senior Credit Agreement with external lenders, under which those lenders provided loans to Mylan and to another subsidiary Mylan Luxembourg 5, to finance the acquisition of the Merck Generics business and refinance Mylan's existing indebtedness. The funds borrowed under the SCA were on-lent to other Mylan group entities to fund the acquisition of MGBBV and other Merck companies.

In October 2007, MAPL issued a promissory note to Mylan Luxembourg 1 in exchange for a promissory note (***PN***) issued by that company (***PN Lux 1***). MAPL used PN Lux 1 to purchase the shares in Alphapharm from MGBBV. As a result, Alphapharm joined the MAHPL tax consolidated group.

Actual transaction:



At issue in the case, were the interest deductions claimed on the PN (issued by MAPL to Mylan Lux 1), that promissory note representing the debt that had been 'pushed down' into the Australian subsidiary. The interest rate on the promissory note was initially floating, but in December 2007, Mylan entered into interest rate swaps to fix the interest rate with external lenders under the SCA. At around the same time (i.e. 2007, but in 2008 on the Commissioner's contention) the interest rate

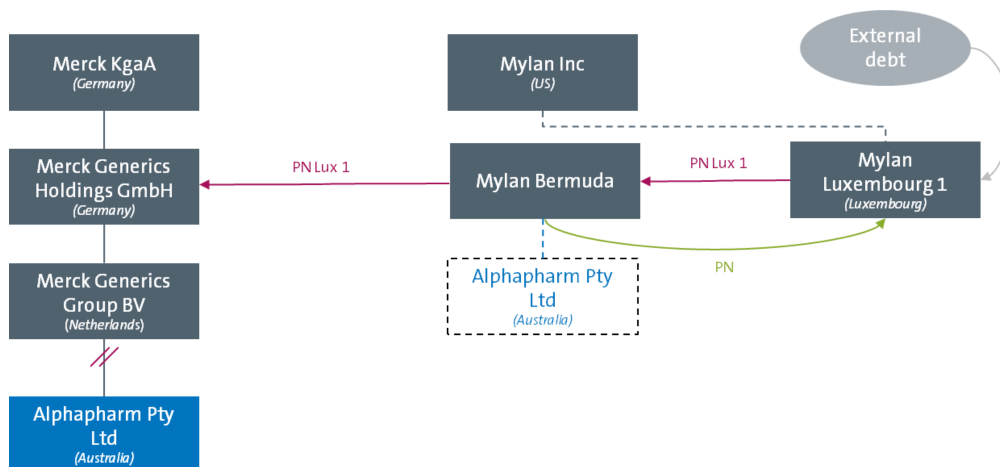
applicable on the promissory note issued by MAPL to Mylan Lux 1 was also determined to be at a fixed rate of 10.15%. The restated principal debt under the main promissory note was ultimately increased to AUD923 million.

5.5.1 Tax benefit in *Mylan*

The primary counterfactual advanced by the Commissioner involved a 'wider' scheme, including the incorporation of MAPL and MAHPL, the amendments to the original SPA to include Alphapharm as a target entity and MAPL as the purchaser, the issue of the promissory notes, the formation of a tax consolidated group, the amendments to insert a new principal amount of AUD923 million, the fixing of the interest rate at 10.15% and the capitalisation of interest.

The tax benefit contended for by the Commissioner was on the basis that, if the wider scheme had not occurred, there would have been no incorporation of the Australian entities, no issue of the promissory notes (i.e. no debt in Australia), and Alphapharm would have been purchased directly by an offshore Mylan entity, with the acquisition financed by borrowing by an offshore entity. In that hypothetical, there would have been no Australian interest deductions.

<u>Commissioner's primary counterfactual:</u>



The Commissioner also relied on a narrower scheme, which did not include the incorporation of MAPL and MAHPL, or the amendments to the SPA to include Alphapharm as a target entity, but did include the issue of the promissory notes, the purchase of Alphapharm by MAPL in exchange for the assignment of a promissory note to MGGBV, the formation of the tax consolidated group, the insertion of a new principal amount and fixing interest rate in the terms of the promissory note issued by MAPL, and certain other steps.

In respect of the narrow scheme, the Commissioner advanced two counterfactuals:

- the secondary counterfactual, which posited that, if the narrower scheme had not been carried out, a **smaller amount of debt** would have been borrowed by MAPL **from external lenders** under Mylan's SCA (senior credit agreement) with a **(lower) floating interest rate** and with Mylan, or other entities in its group, guaranteeing MAPL's borrowing; and
- a tertiary counterfactual, which was materially the same as the secondary counterfactual, but with instead of MAPL borrowing the money from external lenders, it would be borrowed from Mylan or a US subsidiary of Mylan.

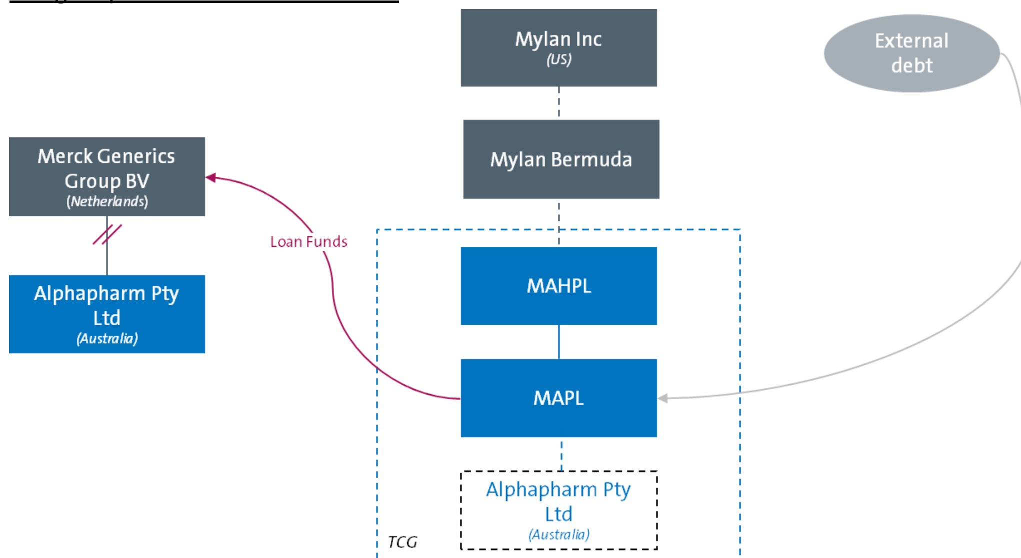
So, the Commissioner's counterfactuals would have given rise to a tax benefit, either on the basis that there would have been no interest deductions under the primary counterfactuals, or there would have been both less debt and a lower interest rate under the secondary and tertiary counterfactuals.

Mylan relied on, in the alternative, two counterfactuals:

- Counterfactual A — that MAPL might be expected to have funded the acquisition of Alphapharm with 25% equity, injected by its parent, and 75% debt **borrowed from the Mylan group** on the same or similar terms as its actual promissory note; or
- Counterfactual B — similar to Counterfactual A, except that the 75% debt would be borrowed **from external lenders** under the SCA with the benefit of a parental guarantee from Mylan, but with cross currency and interest rate swaps to convert its borrowings into AUD and fix the interest rate at a rate of at least 10.15%. And, Mylan contended that MAPL would or might reasonably be expected to have paid Mylan (and/or US subsidiaries of Mylan) **an arm's length guarantee fee** in respect of the guarantee provided in respect of MAPL's borrowings under the SCA.

Ultimately, Button J rejected each of the Commissioner's and the taxpayer's counterfactuals and found that there was nevertheless a tax benefit under her Honour's own, preferred, counterfactual.

Judge's preferred counterfactual:



Button J rejected the Commissioner's primary counterfactual which had as its primary distinguishing characteristic that the acquisition of Alphapharm would be 100% equity funded (ie there would be no debt at the Australian level). Her Honour did not consider that a 100% equity funded acquisition was a sufficiently reliable prediction of what would, or might reasonably be expected to, have occurred.[135] This was for two reasons:

- the primary counterfactual would inflexibly tie up funds equivalent to the purchase price of Alphapharm as equity, when debt is significantly more flexible than equity and a mixture of debt and equity is generally the preferred means of funding subsidiaries; and

[135] Mylan [252]; *Commissioner of Taxation v Peabody* (1994) 181 CLR 359, 385; Federal *Commissioner of Taxation v Ashwick (Qld) No 127 Pty Ltd* (2011) 192 FCR 325, [150]–[152].

- Mylan's Overall Foreign Loss (***OFL***) position in the US was such that it would have been unable to claim any foreign tax credits for income taxes paid in Australia, which would have exposed it to an effective 65% worldwide rate of tax on Australian earnings.

Having rejected the Commissioner's primary counterfactual of 100% equity in Australia,[136] Button J found that she then needed to determine for the purpose of her Honour's counterfactual:

- whether the lender to MAPL would have been an external lender or Mylan (or a group company);
- how much debt would have been incurred relative to equity;
- whether the interest would have been a fixed or floating rate, or a mixture of the two;
- whether interest could be capitalised; and
- whether amortising payments of principal needed to be made.

In other words, the entire capital structure of MAPL needed to be examined for the purposes of determining the preferred counterfactual.

Her Honour rejected the Commissioner's secondary and tertiary counterfactuals that involved 54.6% debt and 45.4% equity, holding that, if the schemes had not been entered into, MAPL would have still capitalised with 75% debt (the then thin capitalisation safe harbour limit).

Button J's preferred counterfactual involved:

- MAPL borrowing the equivalent of AUD785 million on 7 year terms from external lenders under the SCA at a rate consistent with the rate in the SCA;
- MAPL being otherwise equity funded to the extent necessary to fund the acquisition of Alphapharm, and for MAPL stay within the thin capitalisation safe harbour ratio;
- Mylan guaranteeing MAPL's borrowing under the SCA;
- Mylan would not have charged MAPL a guarantee fee;
- Interest on the borrowing would not have been capitalised;
- MAPL paying down the principal on a schedule consistent with that specified in the SCA and making voluntary payments to stay within the thin capitalisation safe harbour;
- MAPL not having fixed its interest rate;
- Currency swaps to swap the borrowings into AUD at a cost of 3.81% p.a. over AUD 3 month BBSW; and
- Mylan or another group company lending MAPL further funds if its cashflow was insufficient to meet principal or interest repayments.

Although the tax benefit was unable to be precisely calculated, Button J held that it would 'appear' that, on the basis of her honour's preferred counterfactual there would be a tax benefit as MAHPL (the head company) would have, or might reasonably be expected to have, claimed less interest deductions than actually claimed. This was because, inter alia, the preferred counterfactual involved a

136 Mylan [303].

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lower, floating rate of interest and did not involve any increase to the initial principal, so the counterfactual involved a **lower quantum of debt** and a **lower interest rate**. It also involved a guarantee without a guarantee fee.

Accordingly, the **tax benefit** was analysed through a counterfactual or hypothetical that (just as might the analysis of a **transfer pricing benefit** in an intragroup financing context) presupposed a different quantum of debt and a different rate of debt deductions.

5.5.2 Dominant Purpose in *Mylan*

In assessing the objective purpose of the scheme, Button J placed emphasis on the eight factors listed in s 177D(2). In her analysis, her Honour found that only one factor supported a finding of dominant purpose, being that Mylan failed to refinance or adjust interest rates in response to changing market rates.[137] This alone was not determinative.

In relation to intercompany financial arrangements, her Honour found that:

- flexibility in intercompany lending including the ability to capitalise interest and defer principal repayments is not indicative of a tax avoidance purpose;[138]
- the use of debt rather than equity to fund subsidiaries can have legitimate commercial rationale; such as providing more flexibility to the parties;[139]
- the existence of non-arm's length terms does not *ipso facto* suggest a tax avoidance purpose;[140]
- the broader commercial context of the a multinational group is relevant when assessing purpose, as a large parent with several subsidiaries might not directly consider the debt carrying capacity of a holding company subsidiary;[141] and
- transaction planning aimed at seeing local country debt track the thin capitalisation limits is not indicative of having a dominant purpose to obtain a tax benefit.[142]

In this case, the Commissioner 'made much' of the fact that the taxpayer had tracked the safe harbour limits for thin capitalisation in relation to its intragroup financing arrangements.[143] Button J held that it was reasonable to hypothesise that at arm's length the taxpayer may have borrowed debt up to the thin capitalisation safe harbour limit in operation at the relevant time; 'that much is to be expected'.[144] Button J held that, in the absence of any intragroup financing, Mylan 'would still have taken on the same level of debt'.[145] These comments appear to support the notion that debt of a quantum which was within (the former) thin capitalisation limits cannot of itself be used to demonstrate a dominant purpose of obtaining a tax benefit.

[137] Ibid 139 [519].
[138] Ibid 138 [512]; 141–2 [526].
[139] Ibid 141 [524].
[140] Ibid 129 [475].
[141] Ibid 129 [474].
[142] Ibid 127 [468].
[143] Ibid 85 [313].
[144] Ibid.
[145] Ibid 86 [316].

6. The interaction between transfer pricing, thin capitalisation, the DDCR and the GAAR

It is possible that an intragroup financial arrangement will be challenged under any or all of the transfer pricing or thin capitalisation provisions, the DDCR and Part IVA. Although Part IVA is an option of last resort,[146] the hierarchical application of the other provisions needs to be carefully considered.

What follows are some observations as to how the different rules may interact.

- **The DDCR and thin capitalisation:** Section 820-31(2) of the ITAA 1997 stipulates that the DDCR applies before the other thin capitalisation rules are applied. This means that any deduction denied under the DDCR is disregarded when applying the thin capitalisation ratio tests.

  Additionally, while the general thin capitalisation rules include an exception for an Australian group where the value of all of the 'Australian assets' held by the group is equal to, or greater than 90% of the value of the total assets of the group, the same exception does not exist in the DCCR regime.

- **Transfer pricing and the GAAR:** In *Mylan,* the Commissioner initially challenged the deductions both under the transfer pricing provisions and under Part IVA. In the end, the Commissioner dropped the transfer pricing case and relied only on the GAAR, albeit unsuccessfully. Despite the ATO ultimately dropping the transfer pricing case, *Mylan* shows that the same financial arrangement has the ability to be challenged under both the GAAR and the transfer pricing provisions and that the Commissioner will be willing to do so in the appropriate circumstances. Both sets of provisions (if they apply) may tax the taxpayer on a hypothetical transaction that may involve a different quantum of debt and a different interest rate to that which applied in the actual transaction.

- **The DDCR and transfer pricing/the GAAR:** The DDCR operates concurrently with both the transfer pricing rules in Subdivision 815-B and the GAAR. However, in theory, the DDCR presents the Commissioner with a less complex, less resource intensive way of challenging an intragroup financial arrangement than both transfer pricing and Part IVA. Specifically, in considering whether the quantum of debt and interest rate are at arm's length in a transfer pricing context, as discussed in Section 3 above, the analysis relies on nuanced expert evidence and complex counterfactuals. Similarly, the 'purpose' element of a Part IVA analysis means that the Commissioner must demonstrate that the dominant purpose of the financial arrangement was to obtain a tax benefit, which also involves complex factual and legal considerations.

  In contrast, although the 'tracing' analysis required under Subdivision 820-EAA may be complex in certain circumstances, the DDCR primarily involves a factual determination of actual fund flows rather than the hypothetical scenarios required in transfer pricing or Part IVA, or the purpose analysis in Part IVA.

  Accordingly, a sensible starting point in any analysis of intragroup financing arrangements is to first consider whether debt deductions are likely to be denied under the DDCR before considering the transfer pricing provisions or the new thin capitalisation provisions. There may be no point determining whether the debt deductions under a particular borrowing represent an arm's length

[146] Explanatory Memorandum, Income Tax Laws Amendment Bill (No.2) 1981 (Cth) 9.

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quantum of debt, or whether the interest rate is an arm's length condition (or whether the debt deductions will be denied under the new fixed ratio test) to the extent those deductions will in any event be denied under the DDCR. However, the interaction between the different regimes may be more nuanced with some proportion of deductions being denied as a result of a tracing and apportionment analysis under the DDCR and some proportion being denied as a result of the application of the transfer pricing rules and/or the application of the fixed ratio test. ATO guidance is awaited on the application and interaction of the these rules.

- **Transfer pricing and the new thin capitalisation rules**: The 'turning off' of s 815-140 for general class investors, as a result of the new thin capitalisation regime now being an 'earnings based' test, means that the new thin capitalisation rules are theoretically to be applied only after the quantum of those deductions is determined under the transfer pricing rules (both by reference to the arm's length interest rate and the arm's length amount of debt). Accordingly, for general class investors, the allowable quantum of debt for tax purposes is now no longer the preserve of the thin capitalisation rules, but rather is to be determined by reference to the arm's length substitution rules in Subdivision 815-B. The earnings based fixed ratio test in Subdivision 820 is then applied as a further step that can also deny the interest deductions on an earnings basis (with the ability to carry forward denied debt deductions for 15 years so long as certain tests are met). Subsection 815-110(2) makes it clear that nothing in Subdivision 815-B limits Division 820 (the thin capitalisation rules) applying after the application of the transfer pricing rules to further reduce debt deductions of the entity.
- **Former thin capitalisation and the GAAR:** Button J in *Mylan* makes clear that just because deductions in relation to an intercompany financial arrangement in the past may have tracked the former safe harbour thin capitalisation limit does not mean that the scheme had a dominant purpose to obtain a tax benefit.

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