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The Chevron Australian Holdings Case and the reach of the arm's length principle

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Abstract

The recent decision by the Full Federal Court in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62 is a watershed, not only in Australia but internationally. It provides important insights into how the arm's length principle takes account of the economic, market and business conditions in which a multinational has to operate. It explores the potential implications arising from the different business practices multinationals adopt for their dealings with independent external entities and those they use for intra-group dealings. The decision may well have impacts beyond the immediate context of intra-group financing, and suggests the latest version of Australia's transfer pricing rules (Subdivision 815-B) has a sound foundation.

Importantly, the Full Court found that when pricing related party loans Australia's transfer pricing rules allow the relevant subsidiary to be seen as part of the wider international group and do not require it to be viewed as a stand-alone entity. A significant breakthrough is the articulation of a reasonable expectation test based on rational commercial behaviour, similar to the approach Australian courts have taken to the operation of the general anti-avoidance provisions in Part IVA. The Full Court explains this as an evaluative prediction of events and transactions based on evidence and, where appropriate, admissible, probative and reliable expert opinion as to what might reasonably be expected if the actual agreement had been unaffected by the lack of independence and the lack of arm's length dealing.

Keywords: Australia's transfer pricing rules, profit shifting, transfer pricing, intra-group financing, independent parties, interest rates, reasonable expectation test.

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Introduction

The Federal Court decisions in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2015] FCA 1092 (the *Chevron Case*); [2017] FCAFC 62 (the *Chevron Appeal*), referred to below collectively as *Chevron Australia Holdings*, have important implications for Australia's transfer pricing rules. Those rules are contained in Division 13 of the *Income Tax Assessment Act 1936*, Divisions 815 A and B of the *Income Tax Assessment Act 1997* and, insofar as relevant to the facts and circumstances in the *Chevron Australia Holdings* matter, the Associated Enterprises Articles in Australia's double taxation agreements generally, but specifically the agreement with the United States of America.

The key facts in *Chevron Australia Holdings* relate to how the multinational group manages the financing of member companies through a central treasury process designed to minimise the cost of external funding - in this case the relevant external borrowings were raised at around 1.2% per annum with the benefit of a parental guarantee - while reducing the equity funding in the Australian operations and on-lending the borrowed funds to the Australian side at around 9%. The 9% interest, including the additional mark up of 7.8%, was paid to a newly incorporated US subsidiary of the Australian holding company of that sub-group that paid its profit (the 7.8% mark-up) back to the Australian holding company in the form of tax free dividends. The arrangement was designed to increase tax deductible interest costs to reduce the amount of company tax paid on the Australian side and to exploit Australia's interest withholding tax[1] and non-portfolio foreign source dividend[2] exemptions so that no tax was payable on the outflow of interest income and the related inflow of dividend income. The Commissioner sought to deny tax deductibility for the 7.8% mark-up, relying on the transfer pricing provisions rather than the general anti-avoidance provisions of Part IVA.

The *Chevron Case* was heard by Robertson J and the *Chevron Appeal* by Allsop CJ, Perram and Pagone JJ. There are important connections between *Chevron Australia Holdings* and the earlier *SNF (Australia) Case*[3], the latter case dealing with the application of the arm's length principle to the pricing of trading stock acquired from overseas related entities. The connections between the cases are discussed below. Some saw the *SNF Case* as limiting the Commissioner's power to make transfer pricing adjustments on the basis that the case was authority for the view that the application of Australia's transfer pricing rules is necessarily and always confined to a pricing of the transactions as structured and implemented between members of a multinational group. The taxpayer also argued that the pricing should be done on the basis that Chevron Australia Holdings was a stand-alone entity and that its connections to the wider Chevron group should be ignored. In the end, the Full Federal Court saw the *SNF Case* as turning on its particular facts, which included the availability of independent arm's length comparable transactions. It is worth noting that Perram J was a member of the appeal court in both the *Chevron Case* and the earlier *SNF Case*.

While the striking down of the tax deductibility of the 7.8% mark up on funding costs in *Chevron Australia Holdings* also depends on the facts and circumstances of the particular

[1] See section 128F of the *Income Tax Assessment Act 1936.*
[2] See the then section 23AJ of the *Income Tax Assessment Act 1936* and [2015] FCA 1092 at paragraph 152 per Robertson J, [2017] FCAFC 62 at paragraph 101 per Pagone J.
[3] *SNF (Australia) Pty Ltd v FC of T* [2010] FCA 635; 2010 ATC 20-190 and on appeal *FC of T v SNF (Australia) Pty Ltd* [2011] FCAFC 74; 2011 ATC 20-265

case, the judgments seem to have implications for multinational groups that have adopted sufficiently similar capital and financing structures and group treasury practices. They also have implications for what may be permissible in the future regarding the charges overseas affiliates may make in connection with the provision of debt funding by a multinational group to its Australian subsidiaries. The decisions are incremental to the history of Australian jurisprudence on transfer pricing and against that broader (but still incomplete) tapestry they provide important insights more generally into the operation of the arm's length principle beyond the immediate context of corporate financing and the different perspectives policymakers, tax practitioners tax administrators have historically brought to this area of the tax law.

One could argue that *Chevron Australia Holdings* is a watershed in transfer pricing practice. The judicial pronouncements in *Chevron Australia Holdings* provide important insights into how the arm's length principle takes account of the economic, market and business conditions in which multinational groups have to operate. They also explore the potential implications arising from the inherent differences between the business models and practices adopted by multinational groups for their dealings with independent external entities, compared to those that are able to be put in place by a group for dealings between group entities that are under common control and ownership. The Full Court approach means that evidence of how the group deals with external parties is a critical factor in applying the arm's length principle. The Full Court judgments make it clear that the arm's length principle has to operate in the context of real world alternative reasonable expectations of agreements between external parties and not in artificial constructs. The subsidiary company taxpayer has to be considered not as a stand-alone entity but as part of a wider multinational group. These judgments now provide a significant obstacle to the narrow, compartmentalised approach to tax planning evident from the taxpayer's arguments and evidence, by rejecting any assumption that the application of Australia's transfer pricing rules is necessarily and always confined to a pricing of the transactions as structured and implemented between members of a multinational group[4].

The following discussion is an evolution of the analysis of the *SNF (Australia)* and *Chevron Australia Holdings Cases* in an earlier paper published in November 2017 in the Journal of Australian Taxation.[5]

The facts in the Chevron matter

The following facts as found by the judges hearing the *Chevron Case* and the *Chevron Appeal* set out the relevant features of the financial relations between the Australian subsidiary and the wider Chevron group.

Essentially, the Chevron group decided to restructure and refinance its Australian sub-group following the merger on 10 October 2001 between two United States corporations, Chevron Corporation and Texaco Inc. A new Australian holding company, Chevron Australia Holdings Pty Ltd (CAHPL), was incorporated on 7 November 2001. At the same time as the reorganisation of the Australian group the US group treasury was developing a

[4] Compare [2017] FCAFC 62 at paragraph 125.

[5] Jim Killaly, *Fair Game, Is Australia Vulnerable or Getting its Fair Share?* 2017 Journal of Australian Taxation, Vol 19 No 3.

recommendation as to the appropriate level of debt for CAHPL[6]. As part of the restructure of the Australian operations of the two merged entities there was a return of capital from Australia to the US (which had the result that the Australian operations were more highly geared) and CAHPL acquired the Australian assets of Chevron and Texaco. CAHPL needed financial support to put these steps into effect. However, neither of these steps required external funding because any financing arrangements between the related parties would wash out on consolidation of the accounts of the newly merged Chevron Group. Nevertheless, CAHPL established a wholly owned US resident subsidiary, Chevron Texaco Funding Corporation (CFC), which raised USD2.5 billion at an interest rate of around 1.2% by issuing commercial paper, transactions that required guarantees to be provided by the AA credit rated ultimate parent company[7].

It was established in evidence that the Chevron group treasury decided when to raise funds from the market to meet the group's cash commitments; that on a whole-of-group basis the group treasury had to make sure that when any member of the Chevron group had to pay money to a third party there was cash there to do so; and that cash was managed by Chevron on a group basis[8].

A Credit Facility Agreement was executed between CFC and its parent CAHPL on 6 June 2003 pursuant to which CFC lent to CAHPL the Australian dollar equivalent of USD2.5 billion at an interest rate of around 9%. Despite the fact that the transactions were internal to the group, Chevron's evidence was that the purpose of the loans was the refinancing of funding for the return of capital and the acquisition of the Australian assets of Texaco[9].

The decisions as to the return of capital, the raising of funds in the United States and the debt level of CAHPL were made by officers of the Chevron Treasury in the United States[10].

The evidence clearly shows that CFC was operated as a Chevron Group Treasury company despite its formal legal status as a subsidiary of the Australian sub-group. CAHPL did not have any of its directors on the board of CFC; CFC did not have any staff of its own; Chevron Treasury had the lion's share of the management of CFC; all of the activities that resulted in CFC doing anything were originated from Chevron Treasury in the US; the decisions that were made by CFC were made by Chevron Treasury staff; and CAHPL was not involved in the commercial paper issues[11].

The inclusion of CFC in the funding loop provided significant tax advantages in relation to the amount of primary company tax payable by CAHPL. The extra interest margin of around 7.8% over the real-world cost of funds that CAHPL paid to CFC was tax deductible on the Australian side (as was the 1.2% real world cost of funds), but the extra margin of 7.8% was returned to CAHPL in the form of a tax exempt dividend under section 23AJ of the *Income Tax Assessment Act 1936*[12]. In other words, the arrangement allowed Chevron to avoid

[6] [2015] FCA 1092 at paragraph 99.
[7] [2015] FCA 1092 at paragraph 138.
[8] [2015] FCA 1092 at paragraphs 143 and 154.
[9] [2015] FCA 1092 at paragraph113.
[10] [2015] FCA 1092 at paragraphs121 and 165; [2017] FCAFC62 at paragraph 20 per Allsop CJ.
[11] [2015] FCA 1092 at paragraph119.
[12] [2015] FCA 1092 at paragraph 152 and [2017] FCAFC 62 at paragraph 101.

paying tax anywhere in the world on the extra interest margin of 7.8%. It also enabled the group to exploit the interest withholding tax exemption under section 128F of the *Income Tax Assessment Act 1936* for interest payments on funds raised in external markets through widely distributed debt instruments ***on the full amount*** of the 9% interest CAHPL paid to its US subsidiary, an aspect that Chevron acknowledged[13].

The CFC loans to CAHPL were made on an unsecured basis and there were no operational or financial covenants. This is not unusual when transactions occur between parties that are under common ownership and control and group funding is centrally managed and controlled. However, it is highly irregular compared to dealings between independent parties, since such covenants are common commercial practice to reduce the lender's risk and better secure the payment of interest and principal under a loan.

Section 3.3 of the Credit Facility Agreement provided that the principal of each Advance was to be repaid around five years later, on the Maturity Date of 30 June 2008, which was later extended to 29 December 2010; and that interest was payable monthly in arrears in Australian dollars. From a commercial perspective, it would have been important that CFC receive sufficient funding to repay the external holders of its commercial paper on maturity.

The evidence from Mr Dalzell, a director of CAHPL[14], was that: the interest rate was set by the group Treasury[15]; it was calculated by reference to the AUD principal amounts borrowed; the initial interest payments were funded with short-term interest free loans from Chevron Overseas Petroleum Inc[16]; and there was a specific payment of USD 22.5 million in interest on 29 December 2010, when the Credit Facility Agreement was terminated and replacement intra-group funding was provided. It appears that the effect of the arrangements was that to a large extent, if not entirely, interest expense on the full amount of the borrowings was in effect capitalised over the life of the loan, as indicated by the higher USD repayment of USD3,746,464,673.31 (being the USD equivalent at that time of AUD3,707,168,685.25) relative to the USD2.5 billion limit on the Credit Facility Agreement[17]. While not covered in the reported judgments, it would appear, though, from a commercial perspective, that CFC would have had to have been put in funds to ensure it could make the 1.2% interest payments to external parties holding its commercial paper on a timely basis and avoid a default that would trigger the parental guarantee.

Robertson J inferred from the balance of the evidence that if CAHPL were borrowing from an independent party, borrowing USD2.5 billion or the AUD equivalent at 8.97% would not have been sustainable[18].

The steps implemented by the Chevron group appear to have had the effect of increasing the debt funding in the Australian operations on 6 June and 26 August 2003 when advances were made, and successively on the capitalisation of most of the interest obligation accrued on the initial drawdowns. This financing strategy, viewed in isolation from the sales performance of

13 [2015] FCA 1092 at paragraphs 98 and 107.
14 [2015] FCA 1092 at paragraph 106.
15 [2015] FCA 1092 at paragraph 124.
16 [2015] FCA 1092 at paragraph 117.
17 Compare *Commissioner of Taxation v Hart* [2004] HCA 26 regarding the application of Part IVA to an arrangement that included the incurring of interest on interest expense.
18 [2015] FCA 1092 at paragraph 165.

the Australian operations and its dividend policy, tended to increase the leverage in CAHPL's balance sheet and progressively increase the tax deductions for interest expense.

Since the repayment of USD3,746,464,673.31 on 29 December 2010 was funded internally by a borrowing from CAHPL's immediate United States parent company, Chevron Australia Petroleum Company, under the terms of a credit agreement dated 17 November 2009[19], the amount of debt funding in CAHPL's balance sheet was maintained at the increased level, including through the capitalisation of previous interest charges.

The evidence before Robertson J established that while the directors of CAHPL formally approved the Credit Facility Agreement and opened bank accounts[20], members of the Treasury of the Chevron group had made the decisions in relation to:

- the reduction of CAHPL's equity via a share buyback;
- increasing the amount of debt in CAHPL's capital structure; and
- the use of CFC for the USD2.5 billion commercial paper issues in the US[21].

According to the evidence of Mr Dalzell, a director of CAHPL who had responsibility for the department that covered Treasury, finance, taxation and compliance for the Australian operations of the Chevron group[22], CAHPL's debt level of USD2.5 billion was chosen to achieve the most tax efficient capital structure for CAHPL[23]. CFC was not taxable in the United States on the interest income it received from CAHPL[24] and was able to derive profits on the 7.8% margin between its borrowing costs and the higher interest rate it charged to CAHPL. Any interest actually paid to CFC was also free from Australian interest withholding tax[25]. CFC returned its profits to its Australian parent, CAHPL, by way of dividends which were exempt from Australian tax[26] under section 23AJ of the *Income Tax Assessment Act 1936*. It seems the claim for the exemption was based on, amongst other things, the fact that CAHPL held a 100% equity interest in CFC (in excess of the 10% threshold required for exemption), CFC was treated as having derived the interest as active business income on the basis that it was carrying on the business of moneylending, and the 7.8% interest margin was treated as giving rise to the derivation of income (and hence profits) from a source outside Australia. CAHPL's entitlement to claim the dividend exemption was not an issue that was contested before the Court.

Chevron did not call Mr Krattebol, the US officer who made all the key financing decisions in relation to CAHPL, to give evidence. In this regard, the Commissioner submitted that what the ultimate parent did, and why, could be inferred from the balance of the evidence, a submission with which Robertson J agreed[27].

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[19] [2015] FCA 1092 at paragraph 118.
[20] [2015] FCA 1092 at paragraph 117.
[21] [2015] FCA 1092 at paragraph 121; [2017] FCAFC62 at paragraph 20 per Allsop CJ.
[22] [2015] FCA 1092 at paragraph 106.
[23] [2015] FCA 1092 at paragraph 121.
[24] [2015] FCA 1092 at paragraphs 126 and 147.
[25] [2015] FCA 1092 at paragraph 107.
[26] [2015] FCA 1092 at paragraphs 126.
[27] [2015] FCA 1092 at paragraph 165.

It can be observed from the facts and evidence in the court reports the Australian tax savings sought by the Chevron group were based on:

(i) Increasing the amount of debt in CAHPL's balance sheet by instituting a share buy-back and causing CAHPL to acquire the Australian assets of the merged group, both elements being financed with debt. This had the effect of adversely affecting the credit rating of CAHPL when assessed on a stand-alone basis;
(ii) Establishing cross-border related party loans between CFC and CAHPL to provide the debt financing and the basis for pricing them;
(iii) Despite the fact that all these arrangements were internal to the Chevron group, establishing CFC to raise external funding of USD2.5 billion at around 1.2% and on-lending it to CAHPL was intended to ensure the 9% interest charge (including the mark-up of around 7.8%) could be imposed on the Australian side and that any interest payments made from CAHPL to CFC would be exempt from interest withholding tax, despite the fact that the USD2.5 billion external funding was actually used elsewhere in the Chevron group;
(iv) Structuring the loans as non-amortising, without any security or operational or financial covenants, to a highly leveraged borrower in order to support the high interest rate charge and the compounding of interest;
(v) Arranging for the payment of interest to be funded by further related party borrowings that would in effect capitalise the interest costs and produce a compounding effect on the calculation of interest expense and corresponding tax deductions; and
(vi) Incorporating CFC as a US subsidiary of CAHPL carrying on a business of borrowing and on-lending to CAHPL. This produced the result that the interest CFC received from CAHPL would be active business income that would not be attributed to Australia under the Controlled Foreign Companies regime[28]. It was also meant that any dividends that CFC would pay to CAHPL out of the profits CFC could accumulate by charging an interest rate margin of around 7.8% over the 1.2% interest rate it had to pay on the USD2.5 billion in commercial paper it issued would be exempt from Australian tax under section 23AJ of the *Income Tax Assessment Act 1936*.

It is clear that the tax planning strategy involves a number of structural as well as transactional elements. In combination, these steps created a cross-border carousel arrangement between onshore and offshore parts of the Australia sub-group to reduce the amount of Australian profits on which the Chevron group would have to pay tax. The mechanics of the arrangement were to ensure that: tax deductible interest expense was maximised in Australia; none of the interest flow to CFC was taxable in the US; no Australian interest withholding tax was payable in respect of the interest outflow to CFC; and no tax was payable in Australia when CFC's net interest income was repatriated to CAHPL in the form of dividends.

[28] Part X of the *Income Tax Assessment Act 1936.*

Findings on legal issues impacting the operation of the transfer pricing rules

Depending on the facts and circumstances, the configuration of legal structures, the allocation of functions and risks, and the reward systems multinational groups use in relation to the various stages in their global economic value chains, may, from a transfer pricing risk assessment perspective, raise a series of issues for investigation[29]. Potential transfer pricing risks may or may not be substantiated on further investigation. However, the transfer pricing issue that was before the Court in *Chevron Australia Holdings* was whether the interest rate of around 9% charged by an associated offshore finance company on the loans to the Australian holding company, CAHPL, representing a margin of around 7.8% above the 1.2% real-world cost of the funding, exceeded the consideration that would have been agreed between independent parties dealing wholly independently with each other. The effectiveness of the carousel tax planning arrangement described above depended on the answer to this question. If the Commissioner was able to successfully reduce the tax deductions for the interest charges then, subject to any additional statutory charges by way of penalty, he would be able to put CAHPL in the same economic position as it would have been in had no overcharging occurred. On this basis the Commissioner may not have seen it as necessary to seek to rely on the general anti-avoidance provisions to cancel the tax benefits that arose in relation to the exploitation of the section 23AJ and 128F exemptions, though there still remains a question of whether the 1.2% interest charge on the real world cost of funds should have been exempt from withholding tax. Another advantage for the Commissioner is the fact that the transfer pricing rules do not require proof that the avoidance of Australian tax was the dominant purpose of the arrangement, something that is complicated in the Chevron scenario by the fact that the Australian operations needed to be refinanced, albeit the overcharging of interest and the avoidance of interest withholding tax may have also been able to be attacked under the general anti-avoidance provisions in Part IVA[30].

As to the transfer pricing issue in contention, this same issue (regarding whether the interest rate was the correct arm's length rate) arose regardless of whether the domestic transfer pricing provisions in Division 13 of the *Income Tax Assessment Act* 1936 or the Australia/US tax treaty rules, incorporated by reference into the *Income Tax Assessment Act 1997* by Subdivision 815-A,[31] were being applied, though the formulation of the arguments is quite different. Division 13 is drafted in transactional pricing terms and in the Chevron circumstances poses the question whether a taxpayer paid an arm's length consideration for property (which includes the provision of finance) acquired under an international agreement[32]. The treaty provisions focus on whether conditions operated in the commercial or financial relations between the parties that differed from those which might be expected to operate between independent parties dealing wholly independently with each other and had the effect that the Australian profits were understated[33]. Were the issue to arise in a current

[29] See for example Chapters 6 and 10 of *Fair Game: Is Australia Vulnerable or Getting its Fair Share?*, Jim Killaly, 2017 Journal of Australian Taxation, Volume 19 No 3.

[30] Subsection 177D(1) of the *Income Tax Assessment Act 1936* limits the operation of the general anti-avoidance provisions to cases where the person or persons who entered into or carried out the scheme or any part of it did so for the purpose of enabling one or more taxpayers to obtain a tax benefit.

[31] See subsections 815-15(1) and (5).

[32] Subsections 136AA(1) and (3), section 136AC and subsection 136AD(3).

[33] Article 9, Associated enterprises, Convention between the Government of Australia and the Government of the United States of America for the avoidance of double taxation and the prevention

year assessment it would now have to be considered in the context of Subdivision 815-B which is framed in very similar terms to the treaty provisions, but is not limited to dealings between enterprises resident in treaty countries or to cases where there is common control or ownership. Subdivision 815-B also expressly applies to relevant conditions that indirectly affect the commercial or financial relations between the parties and result in an understatement of profits[34].

Independent parties dealing at arm's length/wholly independently with each other

Common to each iteration of the statutory arm's length test is a comparison of the relevant aspects of the actual cross-border dealings with what might be expected if the parties were "independent parties dealing at arm's length (or, in the treaty language reflected in subsections 815-15(1) and (5) and 815-125(1), "dealing wholly independently") with each other"[35]. This slight difference in wording between the Division 13 formulation of the arm's length principle and that used in subdivisions 815-A and B does not appear of itself to give rise to any substantive difference in operation, though there are important differences in the scope of each set of provisions. There has been much debate in recent years, reflected in the arguments and decisions in *SNF (Australia)* and *Chevron Australia Holdings*, as to what, if any, regard should be had to the financial profile and circumstances of the particular taxpayer engaged in related party cross-border dealings when applying this arm's length hypothetical[36]. This aspect has been raised in two different ways.

The first is seen in the way the Commissioner presented his argument in *SNF (Australia)* [37]. The taxpayer company was established to provide a marketing and distribution function for manufacturing entities within the group so as to enable the group to penetrate the Australian market and sell more of its products (paragraph 167 of Middleton J's judgment). The group manufactured polyacrylamide products for use in the mining, paper and sewage treatment industries. Despite good sales performance, the Australian entity carrying on business as the local marketer and distributor of chemical products it purchased from offshore associates reported losses in each of the seven income years from 1998 to 2004.

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of fiscal evasion with respect to taxes on income, done at Sydney on 6 August 1982, as incorporated by section 815-15 of the *Income Tax Assessment Act 1997*.

[34] Subsections 815-115(1) and 815-120(1) refer to conditions that operate between entities "***in connection with*** their commercial or financial relations".

[35] In paragraph 73 of his judgment in the context of considering the operation of subsection 136AD(3) of Division 13 Robertson J describes the process as "making the statutory comparison". As Robertson J pointed out at paragraph 609 of his judgment the determination of whether in the context of Article 9 of the US treaty conditions differ from those that would have operated between independent parties dealing wholly independently with each other also requires a comparison. Subdivision 815-A does this by incorporating Article 9 of the US treaty by reference and the machinery of subdivision 815-B achieves it by mirroring the focus on conditions that differ from arm's length conditions. The statutory comparison is also referred to by Pagone J [2017] FCAFC 62, at paragraph 119 of his judgment (in relation to Division 13) and paragraph 156 (in relation to Article 9 as incorporated by reference into Subdivision 815-A).

[36] *SNF (Australia) Pty Ltd v FC of T* [2010] FCA 635; 2010 ATC 20-190 and on appeal *FC of T v SNF (Australia) Pty Ltd* [2011] FCAFC 74; 2011 ATC 20-265; *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2015] FCA 1092; [2017] FCAFC 62.

[37] *SNF (Australia) Pty Ltd v FC of T* [2010] FCA 635; 2010 ATC 20-190 and on appeal *FC of T v SNF (Australia) Pty Ltd* [2011] FCAFC 74.

The financial analysis that was tendered as part of the Commissioner's submission was to the effect that over the relevant period for every $100 of sales it made, the taxpayer incurred selling costs of $28.57, and paid $82.88 for the product it purchased from the related party suppliers, giving rise to a loss of $11.45[38]. The question of whether SNF (Australia) had to offer discounts to increase its sales in accordance with the market penetration strategy, and who should bear the financial cost of any such discounting, is not addressed in the case. While admittedly this is an overall analysis of seven years of operations and represents a set of average costs and revenues, it shows (even if one undertook a year by year analysis) that by far the most significant expenditure by SNF (Australia) was in relation to the purchase of product from offshore associates. It was a cost over which the Australian entity had little if any control, the prices being determined by the parent. As long as the various cost drivers remained constant, and there was no other source of remuneration or reimbursement, the Australian business would continue to make losses from its marketing and distribution activities, despite those activities, driven by the group's market penetration strategy, generating a growing market share (18% of the polyacrylamide market in Australia by 2002[39]). It can reasonably be inferred from the continued support the Australian operations received that the group determined that it was in their best interests to continue to conduct the Australian operations on this basis. However, considered by reference to the likely behaviour of independent marketing distributors dealing wholly independently with their suppliers, the behaviour of SNF (Australia) in conducting its business on this basis appears commercially irrational. The entity is continuing to burn equity. It received continuous and significant equity subscriptions and loans from SNF France[40] as well as price support from the SNF group by way of discounts on the prices of products supplied to Australia[41]. One might speculate that need for loans was more likely associated with the purchase of products, over which the group had flexibility in setting and adjusting terms of payment, while the selling costs were likely to be external costs that became a more immediate demand on sales revenue.

The actual purchases over the seven-year period were the transactions that were observed between SNF (Australia) and its offshore associated suppliers and the ATO case was framed on the basis of that overt relationship. No doubt by reducing the prices charged for those supplies it would be possible to arrive at a margin that an arm's length party would have been likely to require in respect of the economic functions SNF (Australia) performed, the assets it used and the risks it assumed. The Commissioner argued his case on the basis that the prices were higher than would have been agreed between independent parties dealing wholly independently with each other[42].

Middleton J found that the reason for the losses incurred by SNF (Australia) was irrelevant[43]; his task, on the way the case was argued, was confined to determining whether the purchase prices for the products acquired from offshore associates were arm's length. His Honour put it in the following terms,

> "I do not accept the Commissioner's submission that the test is to determine what consideration an arm's length party in the position of the taxpayer would have given

[38] [2010] FCA 635; 2010 ATC 20-190 at paragraph 161(iv).
[39] [2010] FCA 635; 2010 ATC 20-190 at paragraph 162.
[40] [2010] FCA 635; 2010 ATC 20-190 at paragraph 162.
[41] [2010] FCA 635; 2010 ATC 20-190 at paragraph 167.
[42] [2010] FCA 635; 2010 ATC 20-190 at paragraphs 160 to 165.
[43] [2010] FCA 635; 2010 ATC 20-190 at paragraph 157.

> for the products. The essential task is to determine the arm's length consideration in respect of the acquisition. One way to do this is to find truly comparable transactions involving the acquisition of the same or sufficiently similar products in the same or similar circumstances, where, those transactions are undertaken at arm's length, or if not taken at arm's length, where suitable adjustment can be made to determine the arm's length consideration that would have taken place if the acquisition was at arm's length. Just as in a valuation, the focus is not on the subjective or special factors of the parties involved in the transaction (eg whether they were financially sound or not), but is on the transaction itself and the consideration paid. In this sense, the task in not dissimilar to that undertaken in a valuation [citations omitted]."[44]

His Honour accepted that sales of products by the group to independent distributors were reliable comparables and found on that basis SNF (Australia) had not paid prices that exceeded the arm's length prices; in fact his Honour found that the price paid by the taxpayer was almost always less than that determined by the free market[45].

At the appeal stage the Commissioner again sought to argue that one had to have regard to the circumstances of the taxpayer in determining whether proposed arm's length comparables were truly comparable. The Commissioner argued that the arm's length hypothesis created by the definition of "arm's length consideration" in subsection 136AA(3)(d) required:

> "the erection of a statutory hypothesis based on applicable facts; in effect, a statutory deeming provision. The hypothesis was to consist of all the facts in the real world with one fact changed by the deeming provision, namely, the fact that the taxpayer and its parent were not independent of each other. This required one to assume a set of facts in which the purchaser was an entity ***with all the qualities of the taxpayer except its relationship to the parent manufacturers***."[46]

It may be that the expectation that independent parties dealing at arm's length with each other would act in a commercially rational way (and thus have regard to their own individual financial circumstances in negotiating prices for property they were acquiring) was seen as inherent in the assumption encapsulated in the arm's length hypothetical. Given the evidence the Commissioner led in relation to the Australian business losing $11.45 on every $100 of sales and his conclusion that conducting the business on this basis was not commercially rational, the Commissioner's argument seems to have been based on the assumption that a taxpayer acting truly independently from its counterparties will seek to achieve a commercial rate of return for its functions, having regard to the economic and financial risks the taxpayer is assuming, both in terms of its overall business and in connection with the specific cross-border related party dealings that are the subject of the transfer pricing examination.

On this line of argument, it would seem to follow that, regardless of open market prices, the arm's length purchaser would never agree to pay more than it could afford but would always seek a price that would allow it to achieve a commercial rate of return. The difficulty with the argument is that is that it assumes that the financial circumstances of the Australian taxpayer, as established and maintained by the foreign parent, will always determine the outcome of arm's length dealings involving the sale and acquisition of property (or services),

[44] [2010] FCA 635; 2010 ATC 20-190 at paragraph 44.
[45] [2010] FCA 635; 2010 ATC 20-190, at paragraphs 144 to 151.
[46] [2011] FCAFC 74; 2011 ATC 20-265 at paragraph 95.

irrespective of market forces and business conditions. Another difficulty is that it assumes that it is possible to derive an arm's length outcome from a non-arm's length starting point; the taxpayer's financial profile and performance were affected by non-arm's length dealings. More importantly, the argument seeks to redefine the arm's length price, in cases where mispricing was perceived to be the transfer pricing issue to be tackled, as something other than the price (or prices) established in dealings between independent parties dealing at arm's length with each other in the open market. Somehow the fundamental distinction between the tainted structures and dealings on the one hand, and independent comparables on the other, becomes convoluted and the contrived financial position of the taxpayer is argued to be a key ingredient in establishing the acceptable price in cross-border dealings between related parties.

The drafting of Division 13 is based on transactional pricing. It makes the supply or acquisition of property (which includes services) under an international agreement the focus of the pricing examination. It does not address the entire topic of shifting taxable income from Australia; merely one aspect[47]. It does not address other structural elements in the relationships between group companies that could distort the allocation of profits between Australia and other countries, unless these elements can be expressed in transactional terms that raise the issue of arm's length pricing. It does not allow the Commissioner to argue that independent parties dealing at arm's length would not have entered into the actual transaction at all; it operates on the assumption that a transaction has occurred, that property has been supplied or acquired, and simply asks whether the supply or acquisition by an Australian taxpayer occurred at an arm's length price, leaving the Commissioner the discretion to make a contestable determination on that matter. It seems unlikely that CAHPL would have been creditworthy for a USD 2.5 billion five-year loan on the basis of its stand-alone financial profile[48]. However, Division 13 does not address that issue. By contrast, the focus in subdivision 815-A on "conditions" that operate in the commercial and financial relations between the parties that differ from those that would have been adopted by independent parties dealing wholly independently with each other, recognises that associated entities may have dealings which are non-arm's length for reasons apart from the price that is attributed to them[49]. Notwithstanding these differences in scope, there will be a range of cases where the provisions of Division 13 and those of Subdivision 815-A will each apply, the facts and circumstances of the SNF (Australia) and Chevron matters being examples.

In examining the statutory definition of "arm's length consideration" in subsection 136AA(3)(d) the Full Court in *SNF (Australia)* saw the critical words as being the requirement that the arm's length consideration be identified from dealings "between independent parties dealing at arm's length"[50]. They rejected the Commissioner's submission because, contrary to the various permutations that the statutory wording of the hypothetical permitted, it was tantamount to saying in the application of that hypothetical that one of the independent parties must necessarily be the taxpayer. However, it is clear from the way the Full Court specified the permissible arm's length permutations that they were not saying that the taxpayer could never be a party in an arm's length hypothetical.

[47] See [2010] FCA 635; 2010 ATC 20-190 at paragraph 50.
[48] [2015] FCA 1092 at paragraph 165.
[49] See the *Chevron Australia Holdings Case* [2015] FCA 1092 at paragraph 600 per Robertson J.
[50] [2011] FCAFC 74; 2011 ATC 20-265 at paragraph 97.

The Full Court went on to explain that in their view "the description of a transaction as being at arm's length is a statement about the independence of two parties from each other", the connection being described as "a relative one" that "does not carry any information about their absolute status". In their view "it would be unsound to read [the statutory hypothetical] as requiring any more than that the two parties in question should be independent of each other" [51].

The Full Court then considered whether the fact that the definition of "arm's length consideration" fed into an operative provision, subsection 136AD(3), displaced the ordinary meaning they attributed to the concept of "independent parties dealing at arm's length with each other". Broadly, subsection 136AD(3) provided that if, in a case where the Commissioner made the appropriate determination, a taxpayer was found to have paid an amount for the acquisition of property (or services) under an international agreement that exceeded the arm's length consideration, then the taxpayer would be deemed, for all the purposes of the 1936 and 1997 Income Tax Assessment Acts, to have paid only the arm's length amount. Their Honours concluded:

> "..it does not follow from the acceptance of all those features that arm's length consideration – which does not , in general, refer to the actual position of either party – must be treated as overlaid by a further requirement that the consideration not only be at arm's length but that the arm in question be attached to the taxpayer[52]."

In the Commissioner's view the arm's length principle, as internationally recognised, required an analysis involving an inquiry into what a purchaser ***in identical circumstances*** would have paid, but for the membership of the group[53]. The Full Court did not accept that international practice, as articulated in the relevant OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, required an approach that "removed the fact of interdependence and non-arm's length dealing, but otherwise …taking into account all the circumstances which bear on price", as advocated by the Commissioner. They saw such an approach as "deeply impractical" and as seeking to discern "a strict norm of operation, inflexibly requiring one kind of comparable and forbidding all others and it refuses to admit the possibility of making adjustments for differences". In the Court's view the Commissioner's interpretation of the words "independent parties dealing at arm's length with each other" raised the likelihood that there would be no other businesses sharing all the same features of the taxpayer bearing on price. The Court was concerned that taxpayers faced with such a strict test would not be able to produce any comparables meeting the requirements of the arm's length hypothetical reflected in the language of subsection 136AA(3)(d) to be able to discharge their statutory burden of proof in an appeal[54]. Contrary to the Commissioner's submission, the Full Court found that the OECD guidelines "make clear such outcomes were not contemplated at all by the OECD"; "it did not intend that only such rigidly identical comparables should be brought to bear" [55].

The *SNF (Australia)* case demonstrates the importance of correctly specifying the relevant property or services and correctly framing the relevant international agreement in terms of the

[51] [2011] FCAFC 74; 2011 ATC 20-265 at paragraph 98.
[52] [2011] FCAFC 74; 2011 ATC 20-265 at paragraph 99.
[53] [2011] FCAFC 74; 2011 ATC 20-265 at paragraph 101.
[54] [2011] FCAFC 74; 2011 ATC 20-265 at paragraph 102.
[55] [2011] FCAFC 74; 2011 ATC 20-265 at paragraph 103.

real underlying profit shifting problem. The process involves an understanding of the global value chain, business model, relevant markets and the economic contribution being made by the Australian operations. The Commissioner's case was framed on the basis that the products purchased from offshore related party suppliers were overpriced. His argument was confined to the observable transactions and did not consider whether any elements typical of rational independent commercial or financial relations were missing. Framed in this way it was not open to the Court to examine whether SNF (Australia) received an arm's length rate of return for the marketing and distribution services it was providing for the group in the highly competitive Australian market, bearing in mind the additional commercial and financial risks associated with a market penetration strategy. In other words, the Commissioner was asking the wrong question in relation to the risk that taxable profits were being shifted out of Australia.

The second exploration of the relevance of the financial profile and circumstances of the particular taxpayer in applying the concept of "independent parties dealing at arm's length with each other" arose in *Chevron Australia Holdings*. In that case both the Commissioner and the taxpayer argued that regard had to be had to the circumstances of the taxpayer in establishing the arm's length interest rate for loan from CFC to CAHPL for the AUD equivalent of USD2.5 billion. Both the Commissioner and the taxpayer agreed that assumptions about assets, risks and functions of the purchaser of financial accommodation were needed to price the supply. However, the Commissioner argued that Australia's transfer pricing rules required CAHPL to be considered in its context as a subsidiary of the Chevron group, while the taxpayer argued that "independent" in the context of the arm's length hypothetical means independent of all affiliation, so that a subsidiary of a multinational group has to be regarded as a stand-alone entity separate from the group of which it is part[56].

The difficulty from both a tax policy and a tax administration perspective is that the multinational group is in a position to shape the capital structure and financial profile of the Australian subsidiary to limit its profitability. The group could also shape the terms of the related party loan agreement to "insert various unattractive and unrealistic terms…. which are commercially meaningless" because of the intra-group nature of the arrangements "and serve only to increase the price for tax purposes" [57]. Because of the common management and control it exercises, the group could also omit clauses that are standard in loan arrangements between independent parties dealing at arm's length with each other. Accordingly, adopting the stand-alone position of CAHPL as a starting point and being compelled to price the loan on its actual terms and conditions does not provide a sound basis for determining an arm's length interest rate. Such an approach ignores the organisational and market context in which CAHPL is operating and the policy purposes separately articulated in Division 13 and Subdivision 815-A.

As the facts of the Chevron matter set out above demonstrate, the strategy of weakening the capital structure of a borrowing group subsidiary was true of CAHPL during the years of income considered by the Federal Court. The tax planning arrangements involved withdrawing equity and replacing it with debt funding, thereby increasing the deductible interest expense on the Australian side. Additional debt funding was then provided to fund the acquisition of the Australian assets of Texaco.

[56] [2015] FCA 1092 at paragraphs 481 to 485 in relation to the operation of Division 13 and paragraphs 601 to 604 in relation to the operation of subdivision 815-A.
[57] Compare the Commissioner's submission at [2015] FCA 1092, paragraph 495.

At the transactional level the loans were structured as unsecured and not amortising. Much of the interest expense was capitalised. Robertson J noted the evidence of Mr Dalzell, a director and compliance manager of CAHPL, who accepted that if CAHPL were borrowing USD 2.5 billion or the AUD equivalent from an independent party at 8.97% the borrowing would not have been sustainable[58] (since it would not have access to the dividends from CFC that arose from the interest rate arbitrage). On appeal, Pagone J observed that much of the evidence of two key witnesses presented by the taxpayer "was to the effect that a loan such as that obtained by CAHPL would not have been available to a hypothetical company with CAHPL's credit worthiness as a standalone company" [59].

However, in the taxpayer's view, the actual financial position of CAHPL and the actual terms of the Credit Facility Agreement, drawdowns and repayments were the only basis on which the arm's length price could be determined because, in its view, the law did not allow the actual arrangements to be reconstructed.

Robertson J directly addressed the meaning of "independent" in the context of the definition of arm's length consideration in subsection 136AA(3)(d). The definition focusses on what would have been given or agreed to be given if the property (or services) had been acquired under an agreement between independent parties dealing at arm's length with each other. His Honour states:

> One issue of statutory construction between the parties was whether subsection 136AA(3)(d) required that the borrower as an independent party be considered as a stand-alone company. In my opinion, the answer is "no" as this would use the word "independent" as if it meant entirely independent rather than, in a case such as the present, independent of the lender[60].

In the context of Subdivision 815-A he addresses the similar concept in Article 9 of the US treaty in the following terms:

> 607. As to [CAHPL's] reliance on a differentiation between the language of "association" and "independence", it seems to me that the distinction involves a *non sequitur*: to say that a party is independent of another party does not mean or require that either party is independent of all parties[61].

His approach to determining the arm's length consideration for the loan was to:

> "go past shorthand expressions such as 'reconstruction of the transaction' to address an agreement between two parties independent of each other, ***neither party being an actual party to the actual loan***".

However, he did not believe that, although the construct was hypothetical, "the exercise should depart from reality more than is necessary for the hypothesis". Accordingly, he thought that "the exercise, although hypothetical, should remain close to the actual loan" and

[58] [2015] FCA 1092 at paragraph 125.
[59] [2017] FCAFC 62 at paragraph 124.
[60] [2015] FCA 1092 at paragraph 79.
[61] [2015] FCA 1092 at paragraph 607.

he would "give little weight to factors which a lender and a borrower, at arm's length to each other, in the circumstances would not take into account". His Honour was not prepared to proceed on the basis of asking "what form an agreement might have taken if it had been negotiated by entities dealing with each other at arm's length" because "such a construction does not centre on the identification of the property". He did not take the reference in the definition of "arm's length consideration" to the hypothetical "if the property had been acquired under an agreement between independent parties…" as meaning that the hypothetical agreement was "to have the property acquired as its only matter coincident with the actual agreement" [62].

So, what factors did Robertson J see as assisting in constructing the statutory hypothetical? He expressed his analytical process in the following way:

> For present purposes, it is useful to adopt the tool of analysis that, in the hypothetical, the hypothetical independent parties have the characteristics relevant to the pricing of the loan so as to enable the hypothesis to work. Thus, for example, the borrower will be an oil and gas exploration and production subsidiary[63].
>
> This has implications for the interest rate, which would change depending on the borrower's credit rating (and on the rating of the loan agreement), and on whether or not the interest rate should reflect the absence of security, the absence of guarantee or the absence of covenants given by a borrower for the protection of the lender[64].
>
> It is easy to see, at one end, that the loan is one made at a certain time, in a certain amount, for a certain period, at a certain interest rate and with or without security. At the other end, it is more difficult to apply the hypothesis required by section 136AD to ***a hypothetical borrower in place of CAHPL.*** Here, it seems to me, the statutory hypothesis must include what has been shown on the evidence to be relevant in the market in question. For example, if the evidence showed that a lender would take into account in pricing the loan that a borrower independent from the lender was in a particular industry and that the creditworthiness of a borrower in that industry was affected by particular matters going to its capacity to repay the loan and the likelihood that it would do so, then those factors would be relevant. It must therefore be a factor that the borrower was in the oil and gas industry[65]. [Implicit in his Honour's analysis is that the creditworthiness of the borrower is relevant to the application of the arm's length hypothetical. Note also that in paragraph 80 of his judgment his Honour also refers to the relevance of a borrower being a subsidiary.]
>
> Another related question is whether the statutory hypothesis permits or requires to be taken into account that a borrower, ***the hypothetical borrower not being the taxpayer,*** has at the time of the loan certain financial resources which the lender would regard as relevant to the pricing of the loan. In principle, the answer must by "yes". In the present case, does the fact that the non-arm's length nature of the Credit Facility Agreement stems from the common ownership of the borrower and the lender by CVX point to a different answer? Of itself, in my view the answer is "no". ***But that***

62 [2015] FCA 1092 at paragraph 499.
63 [2015] FCA 1092 at paragraph 80.
64 [2015] FCA 1092 at paragraph 81.
65 [2015] FCA 1092 at paragraph 501.

> ***does not have the consequence that the particular relationship between CVX and CAHPL is determinative in the context of the statutory hypothesis. That would be to import the actual entity, CAHPL, into the hypothesis contrary to the decision of the Full Court in SNF 193 FCR 149[66].*** [As an aside, one could argue that the Full Court in the *SNF Case* was concerned about always including the taxpayer as one of the parties to the hypothetical but was not saying that the taxpayer should always be excluded from the hypothetical.]
>
> Applying these general considerations to the facts of this case means the following. ***In my opinion, the correct perspective is that of a commercial lender.*** A commercial lender would not approach the question of the borrower's creditworthiness in the same way as would a credit rating agency[67].
>
> [Emphasis added.]

It appears that Robertson J was not prepared to consider the permissible permutation of arm's length hypotheticals that involves an exploration of what would have happened if CAHPL borrowed the AUD equivalent of USD2.5 billion from an unrelated party in an arm's length dealing. His Honour seems to have felt compelled as a single judge at first instance to take that approach based on his reading of the Full Court decision in *SNF (Australia).* However, there are fundamental differences between the facts and circumstances of *SNF (Australia) Case* and *Chevron Australia Holdings Case*. The *SNF (Australia) Case* was decided on the basis of what are generally referred to as "internal comparables": dealings between the related party suppliers and independent purchasers dealing at arm's length. Given that the arm's length price could be established in that way there was no need to consider the financial position of SNF (Australia) and what it could afford; it was irrelevant. However, in the *Chevron Australia Holdings Case* the property acquired by CAHPL was a loan and the open market practice was to have regard to the circumstances of the borrower in pricing a loan; it was relevant to consider the means that the borrower had to repay, and any options that would be available or necessary to reduce the credit risk for the lender, which in turn would reduce the interest rate on the loan.

The approach suggested by Robertson J presents the conundrum as to what financial profile and whose financial performance is to be used to price the loan if the actual borrower, an acknowledged subsidiary of the Chevron group, is removed from the analysis. How would such a third party's financial profile and performance be relevant or helpful in pricing a loan to CAHPL? Given that the arm's length hypothetical does not exclude the taxpayer from potentially being a party to arm's length dealings his Honour seems to have taken the Full Court decision in *SNF (Australia)* beyond what the statute permitted. In the final analysis, his Honour did not have to address this conundrum of the relevant financial profile for loan pricing because he rested his decision on the basis that the taxpayer had not discharged its statutory burden of proof.

CAHPL had argued that it had paid less than the arm's length price. The Commissioner argued that CAHPL had paid an excessive amount. In the end, his Honour found that security and other covenants would have been provided in arm's length dealings and that the limited consideration given by the taxpayer resulted in the consideration which CAHPL did

[66] [2015] FCA 1092 at paragraph 502.
[67] [2015] FCA 1092 at paragraph 503.

give exceeding the arm's length consideration[68]. He does not say by how much, but the effect of his decision was that the 7.8% mark-up was not tax deductible. So, the question of which financial profile and whose performance should be used to price the loan remained unanswered. His conclusion was essentially that it followed that the taxpayer had not shown that the arm's length consideration assessed by the Commissioner was excessive; namely, the taxpayer failed to meet its burden of proof in the appeal proceedings[69]. After rejecting comparables and methodologies proffered by Chevron, his Honour states:

> In my opinion, therefore, the applicant has not shown that the consideration in the Credit Facility Agreement was the arm's length consideration or less than the arm's length consideration nor proved that the amended assessments under Division 13 of the ITAA 1936 were excessive. ***Division 13 does not permit reasoning that reaches a non-arm's length interest rate on the basis that the actual interest rate is as high as it is because of the rating attributed to the borrower or borrowing, which rating relies on the absence of arm's length consideration given by the borrower.*** This reasoning is an addition to, and independent of, my conclusion at [87] above……[70]

His Honour's rationale was based on his view that the likelihood was that in arm's length dealings the borrower would have provided security and operational and financial covenants in order to obtain a lower interest rate. It seems self-evident that a commercially rational borrower would not pay an independent lender a higher interest rate than it needed to if it had options available to it to obtain a lower rate. However, CAHPL would have to be in a position to provide a sufficient security for loans totalling the AUD equivalent of USD2.5 billion. As a subsidiary of the Chevron group that was subject to group financial policy and control it is unlikely that CAHPL would have had the necessary authority. It is also unlikely that the group would give that permission since it would encumber group assets and restrict cashflows when the group had other options like the provision of a guarantee or a letter of comfort that would ensure CAHPL could get the same (significantly lower) interest rate available to its ultimate parent. Without encumbrance or restrictive covenants the Chevron group could sell down part or all of its interest or otherwise dispose of assets if it so chose and have full flexibility to deal with CAHPL's cashflows and solvency, that flexibility being necessary to optimise both commercial and taxation outcomes from a group perspective.

Another potential difficulty for CAHPL is that a lender may not find a security offered by CAHPL suitable in terms of its ability to mitigate a potential loss on an AUD equivalent loan of USD2.5 billion. The Australian gas project was still in the construction phase (expenditure on the Australian side being the rationale for the loan being denominated in AUD), CAHPL's subsidiaries held the operating assets, the assets were specific-purpose,

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[68] [2015] FCA 1092 at paragraph 87.

[69] Section 14ZZO(b)(i) of the Taxation Administration Act 1953 provides:

In proceedings on an appeal under section 14ZZ to a court against an objection decision:

> (b) the appellant has the burden of proving
>
> > (i) if the taxation decision concerned is an assessment--that the assessment is excessive or otherwise incorrect and what the assessment should have been.

[70] [2015] FCA 1092 at paragraph 525. See also footnote 64.

remote area assets and their value to a large extent depended on the success of the gas production operations.

Robertson J took the view that "implicit support" that CAHPL might obtain from being a member of a much bigger multinational group may be generally relevant when assessing a borrower's credit rating[71]. However, he accepted the taxpayer's evidence and submission that, "in the absence of a legally binding parental guarantee, implicit credit support had very little, if any, impact on the pricing by a lender in the real world"[72].

On the facts as found in the case one could make an even more fundamental point. The poor financial position of CAHPL and the need for ongoing financial support from the group is evident from the facts as found by his Honour. It needed funding support to meet its interest commitments. On appeal Pagone J observed that much of the evidence of two key witnesses presented by the taxpayer "was to the effect that a loan such as that obtained by CAHPL would not have been available to a hypothetical company with CAHPL's credit worthiness as a standalone company"[73]. Accordingly, it is more likely than not that an independent commercial lender would require security over and above what CAHPL itself could offer in order be persuaded to advance the AUD equivalent of USD2.5 billion for a five year or extended term, as well as being necessary to ensure the lowest cost of funding. When these aspects are taken into account it seems inevitable that an independent commercial lender to CAHPL would have required a parental guarantee, a view expressly put in argument by the Commissioner.

The reasonable expectation test in the arm's length hypothetical

The Full Court took a different approach to the notion of "arm's length comparability" implicit in the arm's length hypothetical. From the outset, however, it needs to be borne in mind that the Court was considering a scenario where it was not possible or practicable to exclude the taxpayer in the application of the arm's length hypothetical. In relation to Division 13 they expressed this in terms of: the reasonable expectation of behaviour that would reflect rational commercial behaviour in the environment of an arm's length transaction[74]; an evaluative prediction of events and transactions based on evidence and, where appropriate, admissible, probative and reliable expert opinion as to what might reasonably be expected if the actual agreement had been unaffected by the lack of independence and lack of arm's length dealing[75]. This approach if fundamentally different from an approach that seeks to financially engineer aspects of independent dealing in the market, however rare or extreme, to create a synthetic price in order to maximise the interest charge for a related party loan based on a hypothetical that would be unlikely to occur on those terms, conditions and in those contrived circumstances between independent parties dealing wholly independently with each other.

The reasonable expectation test also aligns with the arm's length hypothetical in Australia's tax treaties, though important differences in the way the arm's length test is framed in Subdivision 815-A relative to how it is framed in Division 13 need to be noted. First, the

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[71] [2015] FCA 1092 at paragraph 605.
[72] [2015] FCA 1092 at paragraph 606.
[73] [2017] FCAFC 62 at paragraph 124.
[74] [2017] FCAFC 62 at paragraphs 46, 60 and 62 per Allsop CJ.
[75] [2017] FCAFC 62 at paragraphs 121 and 126 - 128 per Pagone J (with whom Allsop CJ and Perram J agreed).

Subdivision operates in parallel with Division 13 but prevents the possibility of double jeopardy[76]. By using the mechanism of incorporating the Associated Enterprises Articles of Australia's double tax conventions[77], unlike Division 13, the Subdivision includes a common control test and a limitation to dealings between enterprises of countries that are parties to a double tax convention with Australia. In these respects, Division 13 has a potentially wider field of operation. For example, it can apply to dealings between Australia and tax havens and between independent parties that are not dealing at arm's length with one another. However, by focussing the conditions which operate between associated enterprises in their commercial or financial relations that differ from those that might be expected to operate between independent enterprises dealing wholly independently with one another, and have the effect that any profits which might be expected to accrue to one of the enterprises but by reason of those conditions did not so accrue, the Subdivision encompasses a much wider range of profit shifting strategies than the mispricing of goods and services supplied or acquired by an Australian taxpayer that is the scope of Division 13. For example, the mechanism used in subdivision 815-A is able to deal with cases of mispricing and those where the profit shifting problem is not one of pricing, or not merely one of pricing[78]. While noting the differences in scope, it bears repeating that there will be a range of cases where the provisions of Division 13 and Subdivision 815-A will each apply – as transpired in the *Chevron Australia Holdings Case*.

In applying the reasonable expectation test in relation to determining the arm's length consideration for property acquired Allsop CJ said,

> …***it is paramount to recognise the fiscal and commercial context in which the provisions (and the provisions in Subdivision 815-A of the 1997 Act….) are operating"…..To begin and end with the words of the statute does not reflect a call to narrow textualism; it is the recognition that, ultimately, it is the words used by Parliament which frame the question of meaning, and which will provide the answer to that question of meaning. Context, however, is indispensable, whether as an explicit or implicit consideration.*** It gives the place, the wholeness and the relational reality to the words; it helps prevent linear thinking and sometimes beguilingly simple and attractive logic with words driving meaning to unrealistic and impractical ends; and it helps ascribe meaning conformable with commonsense and convenient purpose gained from the relevant part of the statute as a whole, here Division 13[79].

He went on to say:

> The commercial character of the context of the Division means that the subject "international agreement" (as that phrase is defined in s136AC) will be of infinite variety and possible complexity. In each case, however, the focus of the Division is to bring a commercial reality based on an hypothesis of actors independent of each other to the viewing of a transaction (for the purpose of taxation) in circumstances where that commercial reality so based (for that fiscal purpose) has been distorted by

[76] See section 815-40 of the *Income Tax Assessment Act 1997*.
[77] Subsections 815-10(2) and 815-15(1) and (5) of the *Income Tax Assessment Act 1997*.
[78] [2015] FCA 1092 at paragraph 600 per Robertson J.
[79] [2017] FCAFC 62 at paragraph 3.

considerations that can be described as a lack of relational independence or, to use metaphor, a lack of arm's length dealing between the parties to the transaction[80].

Importantly, his Honour then explores the statutory purpose of Division 13. In his words:

> That is the broad context and purpose of the Division – to bring a transaction, an international agreement, from a state influenced by considerations of lack of independence, to a state reflective of arm's length dealing, for the purposes of fitting the transaction within the taxpayer's affairs in that form consistent with commercial reality based on hypothesised independent dealing.
>
> The words used by Parliament for this task, particularly those in ss136AA and 136AD, should therefore be given meaning and operation conformable with this purpose and conformably with the necessary flexibility of analysis that may be required in applying the statute to the infinite variety of circumstances of commercial life. The provisions should not be interpreted pedantically.[81]

His Honour then proceeded to analyse the tax effects of the related party arrangements put in place by the Chevron group, concluding that:

> [O]perating income that would otherwise have been assessable income was transformed by the deduction for outbound interest and receipt of inbound non-assessable dividends, into non-assessable income[82].

Allsop CJ then explores the terms of the loan arrangement between CFC and CAHPL, comparing and contrasting the protection an intra-group lender has (by virtue of the common control) with the type of financial or operational covenants by the borrower one might expect in a commercial loan made at arm's length. This market survey allows him to discern what is missing from the related party terms and conditions. He says:

> There may be an infinite variety of such covenants, the presence or absence of which, at least as between arm's length parties, affects risk and thus price or monetary consideration. On the evidence here, their absence was not dictated by commercial or operational imperatives; rather their absence can be explained by the protection given to the lender by common control. Likewise the absence of security given by CAHPL or the absence of a parent company guarantee can be explained by a lack of commercial or legal capacity (the former) and intra-group choice (the latter) [83].

His Honour then addresses the nature of process involved in applying the arm's length hypothetical:

> …..the ultimate purpose is to determine the consideration that would have been given (that is implicitly, by the taxpayer) had there not been a lack of independence in the transaction. ***How one comes to that assessment and the relationship between the posited arm's length dealing and what in fact occurred will depend on the***

[80] [2017] FCAFC 62 at paragraph 4.
[81] [2017] FCAFC 62 at paragraphs 4 and 5.
[82] [2017] FCAFC 62 at paragraph 19.
[83] [2017] FCAFC 62 at paragraph 38.

circumstances at hand, and a judgment as to the most appropriate, rational and commercially practical way of approaching the task consistently with the words of the statutory provision, on the evidence available*[84]*.

…The independence hypothesis does not necessarily require the detachment of the taxpayer, as one of the independent parties, from the group which it inhabits or the elimination of all the commercial and financial attributes of the taxpayer being part of the circumstances that gave the commercial shape to the property the subject of the acquisition and that may be relevant to the consideration for the property[85].

…the one fixed and rigid proposition is that the parties to the dealing are posited by s136AA(3)(d) must be independent from each other – mutually independent. It does not follow that the party in the position of the taxpayer in the real transaction (here the borrower) must be disassociated in the hypothesis from its place in the group for whose interests it was borrowing. I do not read *SNF* as requiring the utter disembodiment of both parties from the circumstances of reality if one is seeking to understand not what a market price is for goods was but the consideration that would be given for acquiring a characterised loan from an independent lender. The fundamental purpose of the hypothesis is to understand what the taxpayer CAHPL, or a person in the position of the taxpayer and in its commercial context would have given by way of consideration in an arm's length transaction[86].

….***To a degree, the task required by s136AA(3)(d) necessitates [the depersonalisation of the agreement that was entered into] – it is an hypothesis; but that does not of its nature require the completed "depersonalisation" of the hypothesis from the structure of the facts and relationship present in the reality. The degree and extent of the depersonalisation will be dictated by what is appropriate to the task of determining an arm's length consideration – that is one that satisfactorily replaces what the taxpayer gave by what it should be taken to have given had it been independent of its counterparty*[87]*.***

….the statutory hypothesis in s136AA(3)(d) is one directed to a reasonable expectation as to what consideration would be given, implicitly by the party acquiring the property, that is the party in the position of the taxpayer. Whilst the property remains the same, what consideration would be given for it in the real world of independence may lead, depending on the evidence, to the reasonable expectation of different behaviour on the part of the person in the position of the taxpayer in relation to the giving of consideration for the property and of behaviour by another or others in relation to the dealing and which would reflect rational commercial behaviour in the environment of an arm's length transaction. Such behaviour may affect the terms of the hypothetical agreement in question to the extent that they can be seen as part of the consideration. [88]

[84] [2017] FCAFC 62 at paragraph 42.
[85] [2017] FCAFC 62 at paragraph 43.
[86] [2017] FCAFC 62 at paragraph 44.
[87] [2017] FCAFC 62 at paragraph 45.
[88] [2017] FCAFC 62 at paragraph 46.

….I do not see why the hypothesis for s136AA(3)(d) should not include a borrower in the position of CAHPL with its balance sheet in a group the parent of which is a company such as Chevron. Secondly, his Honour concluded that consideration in the nature of security or operational covenants would have been given. There may have been a question, on the evidence, whether CAHPL was in a position to give security. Certainly, on the evidence, the reasonable expectation wold be that Chevron or a company in Chevron's position would give a guarantee; and so security and any covenants given by CAHPL or the company in its position would be of no relevant consequence….[89]

….***What is the consideration that CAHPL or a borrower in its position might reasonably be expected to have given an independent lender if it had sought to borrow AUD2.5 billion for five years? The answer to this question is to be found in the evidence. Here the borrower in the independence hypothesis is a company in the position of CAHPL. It is part of a group the policy of the parent of which was to borrow externally at the lowest rate possible. Further, it was usual commercial policy of the parent of the group for a parent company guarantee to be provided by it (the parent) for external borrowings by subsidiaries. In those circumstances, the consideration that might reasonably be expected to be given by a company in the position of the taxpayer CAHPL would be an interest rate hypothesised on the giving of a guarantee of CAHPL's obligations to the lender by a parent such as Chevron.***[90]

…Part of the assessment of what consideration is reasonably to be expected to be given are the facts that are likely or reasonably to be expected to attend such a transaction with an independent third party. 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.[91]

Further insights into the reasonable expectation test embodied in the arm's length hypothetical can be gleaned from the judgment of Pagone J, with whom Allsop CJ and Perram J agreed. His Honour's reasoning is reflected in the following passages from his judgment:

The comparison required to be undertaken by s136AD(3) is of the consideration for the property actually acquired with the arm's length consideration (as defined) of a hypothetical agreement. ……***Care must be taken in that task not to lose sight of the objective of Division 13, and the assumption upon which its application is based, namely that there is something able to be compared.*** ….***The model upon which s136AD(3) is based presupposes, in other words, that there exists a comparable agreement able to be compared with the actual agreement under which the consideration for comparable agreement was not affected (a) by the parties not being independent from each other and (b) by not having dealt with each other at***

[89] [2017] FCAFC 62 at paragraph 60.
[90] [2017] FCAFC 62 at paragraph 62.
[91] [2017] FCAFC 62 at paragraph 63.

arm's length in respect of the acquisition. The hypothetical agreement contemplated by the definition of arm's length consideration in s13AA(3)(d) does not compel one of the parties necessarily to be the taxpayer (see *Federal Commissioner of Taxation v SNF (Australia) Pty Ltd* (2011) 193 FCR 149 [9], [97]-[102]).[92]

Section 136AD(3), unlike s136AD(4), presupposes, and can only operate, where it is possible and practical to ascertain an arm's length consideration for the supply or acquisition in question. Accordingly, s136AD(3) may not apply to some non-arm's length supplies or acquisitions. It is, of course, neither necessary nor desirable to express a concluded view about the matter, but may be helpful to note that it is not difficult to imagine property (such as, perhaps, a license to use certain intellectual property rights, internally generated know how or central management corporate services or finance) to which s136AD(3) might not, but to which s136AD(4) might apply. ***The significance in the difference between the operation of s136AD(3) and s136AD(4), however, lies in the role in the former of the assumption that there is an arm's length consideration objectively able to be ascertained for the acquisition of the property in question. Central to the application of s136AD(3) is, therefore, the factual ascertainment of an arm's length consideration by reference to the standard of reasonable expectation upon a hypothesis of an agreement made between them as independent parties dealing at arm's length.***[93]

…. ***On CAHPL's construction [of the definition of arm's length consideration] it was submitted that the application of s136AD(3) required pricing a hypothetical loan which a hypothetical CAHPL could obtain from a hypothetical independent party on the assumption that the hypothetical CAHPL had the attributes of the actual CAHPL but was otherwise independent. However, to apply s136AD(3) in that way, would be unrealistic and contrary to its purpose.***[94]

…..The arm's length consideration to be ascertained for the purposes of s 136AD(3) is to be determined by reference to the two criteria found in s 136AA(3)(d); namely, (a) that the arm's length consideration meets the objective standard of being that which might reasonably be expected in relation to the acquisition, and (b) that the standard of reasonable expectation be determined upon the hypothetical basis that the property had been acquired under an agreement in which the parties were independent and were dealing at arm's length with each other in relation to the acquisition. ***The focus of the inquiry called for by these provisions is an alternative agreement from the one actually entered into where the alternative agreement was made by the parties upon the assumptions that they were independent and dealing at arm's length. ….The provisions do not require the construction of an abstract hypothetical agreement between abstract independent parties. The hypothesis in the definition of arm's length dealing is of an agreement which was not affected by the lack of independence and the lack of arm's length dealing. The task of ascertaining the arm's length consideration is, therefore, fundamentally a factual inquiry into***

[92] [2017] FCAFC 62 at paragraph 119.
[93] [2017] FCAFC 62 at paragraph 121.
[94] [2017] FCAFC 62 at paragraph 125.

what might reasonably be expected if the actual agreement had been unaffected by the lack of independence and the lack of arm's length dealing.[95]

The standard of reasonable expectation found in the words "might reasonably be expected" in s 136AA(3)(d) calls for a prediction based upon evidence. In Federal Commissioner of Taxation v Peabody (1994) 181 CLR 359 the High Court said at 385:

> ***A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable.***

The prediction contemplated by Division 13, like that contemplated by s 177C of the 1936 Act, involves an evaluative prediction of events and transactions that did not take place but the prediction must be based upon evidence and, where appropriate, upon admissible, probative and reliable expert opinion: see *Federal Commissioner of Taxation v Futuris Corporation Ltd* (2012) 205 FCR 274 at [79]-[81]; see also *Peabody v Commissioner of Taxation* (1993) 40 FCR 531, [39] (Hill J).[96]

The need to posit a hypothetical acquisition under an agreement for the purpose of evaluating it by reference to the standard of reasonable expectation requires a consideration of the evidence to determine a reliably comparable agreement to that which was actually entered into. That, as his Honour said at [499] required the hypothetical to remain close to the actual loan. ***The function of the hypothesis is to identify a reliable substitute consideration for the actual consideration which was given or agreed to be given, and the reliability of the substitute consideration depends upon the hypothetical agreement being sufficiently like the actual agreement.*****…..*****The characteristics of the purchaser must be such as meaningfully to inform an inquiry into whether the consideration actually given under the agreement exceeded the arm's length consideration under the hypothetical agreement; or, to use the words of the learned trial judge at [80], in the hypothesis the independent parties are to have the characteristics relevant to the pricing of the loan "to enable the hypothesis to work". The actual characteristics of the taxpayer must, therefore, ordinarily serve as the basis in the comparable agreement. That does not mean that all of the taxpayer's characteristics are necessarily to be taken into account.*** The decision in *SNF* is an illustration of a feature of the taxpayer (namely that of having a history of incurring losses) being held not to be relevant to determining the arm's length price of an arm's length acquisition. In some cases the consideration that might reasonably be expected to be given in an agreement in which the parties were independent and dealing at arm's length may be found in comparable dealings in an open market. ***What may readily be ascertained as the consideration in an open market for the property in question may supply the answer to the question but in each case the inquiry called for is a factual inquiry into the consideration that might reasonably be expected to be given in an agreement which did not lack independence between the parties and in which they dealt with each other at arm's length***.[97]

[95] [2017] FCAFC 62 at paragraph 126.
[96] [2017] FCAFC 62 at paragraph 127.
[97] [2017] FCAFC 62 at paragraph 128.

….In each case the focus of inquiry must be to identify a reliable comparable agreement to the actual agreement by the actual taxpayer for the legislative assumption to have meaningful operation. ***The provisions of Division 13 are intended to operate in the context of real world alternative reasonable expectations of agreements between parties and not in artificial constructs.*** The comparable agreement may, therefore, usually assume an acquisition by the taxpayer of the property actually acquired under an agreement having the characteristics of the agreement as entered into but otherwise hypothesised to be between them as independent parties dealing with each other at arm's length in relation to that acquisition….[98]

The prediction of what might reasonably be expected is not to be undertaken upon the hypothesis submitted on behalf of CAHPL that it was not a member of the Chevron group or, in the language sometimes used in this context, as if it were an orphan. To do so would distort the application of Division 13 and fundamentally undermine its purpose of substituting as a comparable a real world arm's length consideration that consideration which could predictably have been agreed between them on the hypothesis that they had been independent and dealing at arm's length. The ultimate object of the task required by Division 13 is to ensure that what is deemed as the consideration by s 136AD(3) is the reliably predicted amount which CAHPL might reasonably be expected to give or to have given by way of consideration rather than a hypothetical consideration without reliable foundation in the facts or reality of the circumstances of the taxpayer in question. That, if it be relevant, is consistent with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations: see I [1.20], [1.27] and [1.31].[99]

In this case the property to be considered in the hypothetical agreement was a loan of US$2.5 billion for a term of years. What CAHPL obtained were the rights, benefits, privileges and facilities of a loan of US$2.5 billion in accordance with the Credit Facility Agreement for a number of years for a consideration which did not require it to give security. His Honour found at [87] that an independent borrower like CAHPL dealing at arm's length would have given security and operational and financial covenants to acquire the loan obtained by CAHPL……..There is no reason to depart from that conclusion. It is not to the point that CAHPL, if it were a standalone company, had a risk rating on a scale approximately equal to BB+ loans. It can be accepted, as was submitted for CAHPL, that its credit profile was critical to the pricing of loans available in the market in question but ***the credit profile of the "hypothetical CAHPL" is not the inquiry required by s 136AD(3). The inquiry was not to determine the price of a loan which CAHPL obtained from CFC, nor to price a loan like that loan which CAHPL (with its credit worthiness) might have been able to obtain, as an independent arm's length party to such a loan, but to make a prediction about what might reasonably be expected to be given or agreed to be given under a hypothetical agreement if the parties had been independent and were dealing at arm's length in relation to the acquisition.***[100]

[98] [2017] FCAFC 62 at paragraph 129.
[99] [2017] FCAFC 62 at paragraph 130.
[100] [2017] FCAFC 62 at paragraph 131.

> The evidence before, and found by, his Honour amply supported his Honour's prediction of the reasonable expectation of a borrowing by CAHPL being supported by security. Its subsidiary, CFC, had borrowed on the market by issuing its commercial paper with a guarantee from its ultimate American parent. ***It was Chevron policy that CVX in California ultimately decided all matters concerning internal restructures including the extent to which subsidiaries were financed by debt or equity. The policies of Chevron were that no external financing could take place unless Treasury or CVX, or another department of CVX, approved of the borrowing. An objective of the group was to obtain the lowest cost of funding to the group for external borrowing.***[101]
>
> ***An alternative submission made by CAHPL, however, does have some force. The alternative submission was that the hypothetical acquisition would need to assume that CAHPL had paid a fee to its parent for the provision of security on the hypothetical loan.*** CFC actually raised funds in this case through a commercial paper program with the benefit of a guarantee from its ultimate United States parent which had a AA credit rating. CAHPL did not enjoy that credit rating and could not have borrowed US$2.5 billion on comparable terms to its parent without a guarantee supported by its parent. CFC did not pay a fee to the ultimate United States parent for the benefit of the guarantee but there is force in the proposition that a cross-border guarantee by the United States parent for the benefit of its Australian subsidiary to raise funds in the United States market with the benefit of a guarantee from the United States parent might have attracted a fee from CAHPL to CVX. The OECD guidelines contemplate that a cross-border guarantee by a parent to a subsidiary may require the payment of an arm's length guarantee fee. The payment of such a fee might not be part of the consideration payable by CAHPL to the lender but the meaning given to "arm's length consideration" in s 136AA(3)(d) is not confined to the consideration moving only between the parties to the transaction. ***What may constitute "consideration" for the hypothetical in s 136AD(3) (as defined by s 136AA(3)(d)) is not to be construed narrowly and includes that given by the acquiring party so as to move the agreement whether that be in money or in money's worth***: *Archibald Howie Pty Ltd v Commissioner of Stamp Duties (NSW)* (1948) 77 CLR 143 at 152; *Chief Commissioner of State Revenue v Dick Smith Electronics Holdings Pty Ltd* (2005) 221 CLR 496 at [71]-[72]; *Commissioner of State Revenue (Vic) v Lend Lease Development Pty Ltd* (2014) 254 CLR 142 at [43], [49]-[51]. ***The definition is broad enough to encompass all consideration relevantly given by the party receiving the property in respect of the acquisition whether paid to the transferor of the property or to a third party such as, in this case, hypothetically to the parent company upon the hypothesis of the payment of a fee. In this case, however, there was insufficient evidence on the case as conducted to warrant the conclusion that a fee might reasonably have been expected to have been paid by CAHPL as part of the consideration that CAHPL might give in respect of the hypothetical loan.***[102]
>
> [Emphasis added.]

Pagone J also saw the application of Subdivision 815-A as involving "a factual enquiry to determine the amount of profits which have accrued and a prediction about what might have

[101] [2017] FCAFC 62 at paragraph 132.
[102] [2017] FCAFC 62 at paragraph 133.

been expected to accrue but for [the non-arm's length conditions]" [103]. His Honour went on to say that,

> ….The comparison which Article 9 required to be undertaken is akin to that contemplated by Division 13. The object was to determine whether conditions actually prevailing between the relevant enterprises differed from those which might be expected to operate if they had been independent and had been dealing wholly independently with each other. The hypothetical in that exercise is undertaken for the purpose of determining whether the dealing which actually occurred might have been expected to occur on different terms. That will generally require that the parties in the hypothetical will generally have the characteristics and attributes of the actual enterprises in question. ***The comparison required by Article 9 is expected to be undertaken in a practical business setting of potential transactions able to be entered into and which are to be used as a basis for a reliable hypothesis upon probative material***….[104]
>
> [Emphasis added.]

Conclusions

The analytical approaches adopted by Allsop CJ and Pagone J have underlined the centrality of the reasonable expectation test in transfer pricing analysis, both in relation to Division 13 and Subdivision 815-A, noting however that Division 13 is cast in terms of the arm's length consideration, while Subdivision 815-A is drafted in terms of profits being understated relative to what would have occurred under arm's length conditions. Their approaches frame the transfer pricing analysis in fairly broad terms that encompass the relevant aspects of the group's business model, financial strategy, treasury processes, commercial and operational imperatives and open market practice as essential elements to be weighed in reaching the prediction required by the arm's length hypothetical. It may be that where the transfer pricing issue is confined to the purchase price of goods or services there is a market for the particular good or service and a market analysis can be undertaken to establish an arm's length price or prices, as transpired in the *SNF (Australia) Case*. In such cases the price (or range of prices) established by such a process can be reliably accepted as arm's length where transactions are sufficiently comparable and are unaffected by non-arm's length conditions. Nevertheless, it seems inherent in the reasonable expectation test that the options realistically available within the arm's length hypothetical need to be explored within the context of how the group as a whole directs, guides and coordinates its business operations and its dealings with outside parties. The Full Court contrasted this with the way that dealings that were purely internal to the group and under its full control were actually carried out, taking account of the tax consequences that flowed from the internal structures and processes relative to the tax consequences that flowed when the statutory purposes of Division 13 and Subdivision 815-A are properly applied. The analyses reflect the implicit expectation in these statutory tests that independent parties dealing at arm's length would deal with each other in a commercially rational manner that would seek to protect and enhance their profits. In the *Chevron Australia Holdings Case* this was aligned with keeping group costs to a minimum in order to optimise overall profitability. It was the weighing of these various

[103] [2017] FCAFC 62 at paragraph 145.
[104] [2017] FCAFC 62 at paragraph 156.

considerations that led the Full Court to its prediction of what would happen if the impugned internal funding arrangements were conducted at arm's length.

The analytical approach adopted by the Full Court in applying the reasonable expectation test has clear implications for the type of evidence needed to support the predictions required by Division 13 and Subdivision 815-A (and Subdivision 815-B going forward) in their respective formulations of the arm's length hypothetical. The *Chevron Australia Holdings Case* shows that this evidence may be in relation to how the group as a whole deals with external parties in the conduct of its business, the commercial and operational imperatives it faces, and the results in terms of profits and prices it achieves through its established processes for dealings with external parties relative to the outcomes its achieves in its internal dealings. In other cases it may involve establishing the prices in the market for truly comparable dealings between independent parties for the supply or acquisition of goods or services, as happened in the *SNF (Australia) Case* and was relevant in the *Chevron Australia Holdings Case* in terms of establishing Chevron's real world cost of funds, subject to the possible caveat that the real transfer pricing issue was not argued in the *SNF (Australia) Case*. Those decisions reinforce the reality that there is no single approach to the construction of the different arm's length hypotheticals dictated by Division 13 and Subdivision 815-A (or Subdivision 815-B), but that the appropriate approach will depend on the true nature of the transfer pricing issue, the terms and mechanics of the particular statutory provisions being applied and the facts and circumstances of the particular case.

That said, the Full Court decision in the *Chevron Australia Holdings Case* is a watershed in transfer pricing practice in relation to multinational group funding strategies. The decision will have international significance because it forecloses strategies that are based on artificially increasing the funding costs of a subsidiary above the group's real world cost of funds. The decision raises questions as to what, if any, margin is appropriate for a parent company to charge on debt funding multinational groups provide to their subsidiaries.

The decision also appears to have implications for international tax planning strategies in relation to corporate financing that seek to compartmentalise transactions in a way that divorces them from their commercial or group context. This will be particularly relevant to the use of parental guarantees.

While his Honour was not required to make a finding in relation to a possible allowance for a guarantee fee, Pagone J's judgment, citing the OECD position, leaves open the possibility of such charges in relation to the provision of parental guarantees should a case be able to be made out.[105] The impact of parental guarantees in most cases in optimising the financial strength of the group as a whole, by in effect endowing a subsidiary with the parent company's financial profile, can readily be acknowledged; as can their tripartite nature. The difficult part is determining what, if any, charge could be appropriately levied on a group subsidiary in cases where its parent provides a guarantee, given the integrated, interdependent and synergistic way in which group financing and capital management is conducted.

[105] [2017] FCAFC 62 at paragraph 133. The OECD guidance referred to appears to be that contained in paragraph 7.13 of the 2010 Transfer Pricing Guidelines. Some of the difficulties with intra-group guarantees were discussed in 2017 Journal of Australian Taxation, Volume 19 No 3 at pages 62-64, 73-75 and 109. See also the further discussion below.

It would be reasonable to expect that multinational groups and their advisers will now consider whether guarantee fees are able to be charged under the approach of the Full Court in the *Chevron Australia Holdings Case* to the application of the arm's length principle. There are similarities in market practice for determining the availability and pricing of guarantees and of loans. Guarantee fees in arm's length dealings are based on the benefit in lower interest rates that the borrower obtains from the ensuing credit enhancement. Complex issues can arise from the fact that guarantees can be used to support thinly and under-capitalised subsidiaries that would not be viable on a stand-alone basis, but have been established and maintained on that basis to optimise financial and fiscal outcomes on a whole of group basis. In such cases subsidiary funding, liquidity and financial risk management fall within the group's overall treasury and financing framework. It does not seem possible or appropriate that a weak capital structure imposed on a subsidiary by its parent in order to optimise business outcomes at a group level is used as a basis for calculating a guarantee fee that is capable of aligning with the arm's length hypothetical[106]. In any event, the funding strategy is inextricably linked to the business operations and assets, both at the group and subsidiary levels; it does not make sense from a transfer pricing perspective to examine an aspect of corporate financing, whether internal interest rates or guarantee fees, divorced from the real world business and market context and the group's capital management and financial strategies. Nor should the analysis be divorced from the statutory purposes underling the various iterations of the arm's length principle in Division 13, Subdivision 815-A and Subdivision 815-B[107].

At a practical level, because it depends on there being something that is able to be compared, the application of the arm's length hypothetical in the case of intra-group guarantees may be hindered by an absence of arm's length transactions involving a third party provision of a financial guarantee for a subsidiary of a different group[108]. This is particularly likely given information asymmetries would make third parties reluctant to provide a guarantee where the parent company does not do so. The potential absence of arm's length comparables in relation to group finance arrangements was alluded to by Pagone J in the context of considering the operation of Division 13 and the role of subsection 136AD(4) [109].

The OECD has acknowledged that associated enterprises can make a much greater variety of contracts or arrangements than can independent enterprises because the normal conflict of interest which would exist between independent parties is often absent, a circumstance that allows them to be subsequently varied, suspended or terminated[110]. In such cases the OECD recommends tax administrations determine the underlying reality behind a contractual arrangement in applying the arm's length principle. It seems that such an approach is appropriate to the analysis of group capital management and finance strategies adopted by some multinational groups. This is in effect what the Full Court has done in the *Chevron Australia Holdings Case* in the way it has gone about applying the reasonable expectation test embodied in Division 13 and Subdivision 815-A (and now reproduced in Subdivision 815-B).

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[106] Compare paragraph 1.65, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, July 2010.
[107] See [2017] FCAFC 62 at paragraphs 3-6 and 89-91 per Allsop CJ and paragraphs 119, 125, 129 and 156 per Pagone J.
[108] See [2017] FCAFC 62 at paragraphs 119, 121, 126 and 156 per Pagone J.
[109] [2017] FCAFC 62 at paragraph 121.
[110] Paragraph 1.67, *op cit*.

If one adopts the contextual approach that the Full Court has outlined for the application of the reasonable expectation test in the arm's length hypotheticals in Division 13 and Subdivision 815-A, which seems equally applicable to Subdivision 815-B, it could be argued that, in most if not all cases, the reasonable expectation would be that a parent company would provide a guarantee itself and not allow group companies to incur guarantee costs that would reduce both the subsidiary's and the group's profits[111]. There remains a question of whether the provision of the parental guarantee "provides a respective group member with economic or commercial value to enhance its commercial position", which depends on whether an independent enterprise in comparable circumstances would be willing to pay for what has been provided. This is the test that the OECD articulates for determining whether an intra-group service has been provided[112].

The parent obtains a commercial and a financial benefit from providing the financial guarantee for an external loan, that benefit accruing in the form of the increased profits or reduced losses in its subsidiary and on a consolidated basis. The group can deal with the provision of the guarantee within its frameworks for capital management and group funding and the parent does not have to set aside equity capital to cover the guarantee in the way that would be necessary if a guarantee were provided to an independent party. The group may also gain tax advantages through the use of thinly or undercapitalised structures in subsidiary companies that are supported as and when required by such guarantees (or perhaps letters of comfort or other financial assurances). The associated interest charges and guarantees can have the effect of reducing the profits that are subject to Australian tax below what would have occurred on an arm's length basis.

The OECD guidance on intra-group guarantees relevant at the time of the Chevron Case was limited. Paragraph 7.13 of the 1995 Transfer Pricing Guidelines, which is mirrored in the 2010 version, states by way of examples that:

> [No] service would be received where an associated enterprise by reason of its affiliation alone has received a credit rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member……

It seems counterintuitive to suggest that the OECD guidance was intended to cover the charging of intra-group guarantee fees in circumstances where the fees are part of an arrangement that results in the understatement of profits in the borrower country relative to what would occur at arm's length. This would defeat the policy purpose behind the Associated Enterprises Article in the OECD Model Double Taxation Agreement (and Division 13, Subdivision 815-A and Subdivision 815-B). Nor would it seem commercially rational to pay a guarantee fee in circumstances where a borrowing subsidiary has been established and maintained on the basis that it is technically insolvent but is kept afloat by a range of non-arm's length arrangements. In such cases, like the fact scenario in *Chevron Australia Holdings*, the guarantee and associated guarantee fees in respect of a borrowing would not be providing economic or commercial value to the borrower subsidiary to enhance its commercial position in the sense intended by the OECD guidelines. Taken together with the weak capital structure and indebtedness typical of such cases the combined effect is to

[111] Compare [2017] FCAFC 62 at paragraph 63 per Allsop CJ and at paragraph 156 per Pagone J.
[112] Paragraph 7.6, *op cit* and mirrored at paragraph 7.6 of the 2010 version.

strip value out of the subsidiary contrary to the purpose of the Associated Enterprises Article. Such cases fit more conformably within the ambit of paragraph 1.37 of the 1995 OECD guidelines, mirrored in paragraph 1.65 of the 2010 OECD guidelines, where tax administrations could justifiably disregard the structure adopted by the taxpayer in entering into the controlled transaction.

At the end of the day the policies articulated with varying scope in Division 13, Subdivision 815-A (and now Subdivision 815-B) are directed to addressing cross-border arrangements that result in the understatement of profits subject to tax in Australia. It will be a matter of evidence whether, having regard to business and market context and relevant evidence of arm's length dealings, the Australian profit has been understated or overstated. If, relative to the statutory purpose, it could be shown that the Australian profit would be overstated without an appropriate allowance for the credit wrap benefits provided by a parental guarantee, a more holistic transfer pricing methodology could produce an arm's length profit outcome on the Australian side. However, compartmentalisation of the issue of guarantees and guarantee fees, divorced from their group and market context and the relevant statutory purpose, runs the risk of undermining Australia's transfer pricing rules.

Time will tell how this issue of parental guarantees unfolds. Interested parties will have to stay tuned for the next exciting episode.