

Tax Alert

Transfer pricing rules take priority over debt/equity rules

The Australian Taxation Office's newly released Taxation Determination could lead to unexpected outcomes for taxpayers.

Issued in July 2019, the Australian Taxation Office's (ATO's) Taxation Determination (TD) 2019/10 confirms the application of the debt and equity rules detailed in Division 974 of the Income Tax Assessment Act 1997 (Div 974) do not limit the operation of the transfer pricing rules set out in Subdivision 815-B of the ITAA 1997 (Subdiv 815-B). TD 2019/10 applies retrospectively to income years commencing on or after 29 June 2013 (coinciding with the commencement of Subdiv 815-B).



What does this mean, practically?

The upshot of TD 2019/10 is that the debt v equity rules and the transfer pricing provisions can treat the same loan transaction differently for tax purposes. This can lead to unexpected outcomes for taxpayers and can be a significant tax trap.

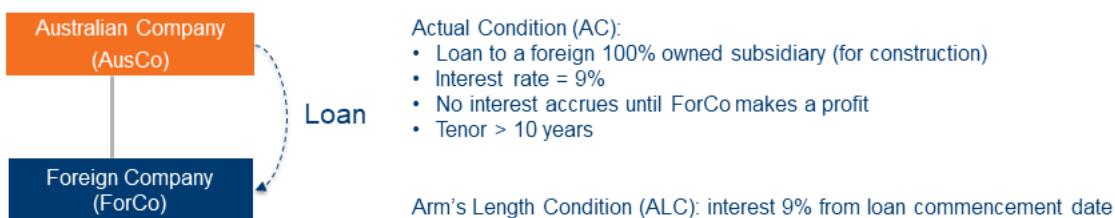


The actual terms and conditions (actual conditions) of related party arrangements can be different to the terms and conditions which would exist between arm's length parties (arm's length conditions). Where they are inconsistent and a transfer pricing benefit (generally a reduction in taxable income or increase in losses in Australia) is derived, Subdiv 815-B will substitute the actual conditions with arm's length conditions. [Div 974 will apply to the substituted conditions, not the actual conditions.](#)



TD 2019/10 Examples¹

Example 1 - Outbound loan to a distressed subsidiary



Apply Div 974 to	Characterisation	Result
AC	Equity interest	Non-assessable non-exempt (768-A)
ALC	Debt interest	Assessable interest

TP benefit

The first example concerns an interest bearing outbound loan to a related foreign company which satisfies the Div 974 equity test (as there is no non-contingent obligation to pay interest), and therefore any income arising from the arrangement would be treated as non-assessable, non-exempt income under Subdivision 768-A of the ITAA 1997.

Had arm's length conditions operated instead of the actual conditions, there would be a loan with interest that would have accrued from commencement of the loan term at a rate of 9%. Consequently, a transfer pricing benefit would be deemed to have arisen. Applying Div 974 to the arm's length conditions, the loan would give rise to an assessable debt interest.

Example 2 - Inbound discretionary interest loan

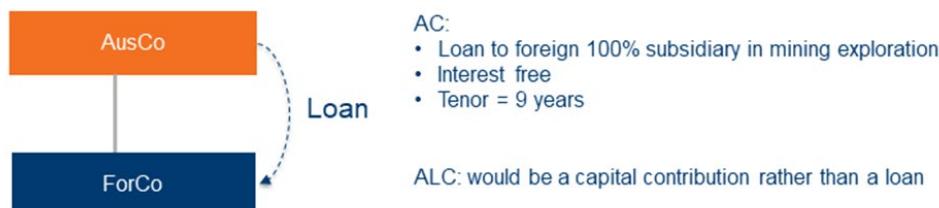


Apply Div 974 to	Characterisation	Result	
AC	Equity interest	No Interest WHT	TP benefit
ALC	Debt interest	Interest WHT	

The second example involves an inbound loan with discretionary interest, which satisfies the equity test in Div 974 due to a non-contingent payment obligation. Had the arm's length conditions operated instead of the actual conditions, ForCo would have made a loan to AusCo with interest on the outstanding principal accruing periodically and an obligation to pay all outstanding accrued interest at the end of the loan term.

Consequently, a transfer pricing benefit would be deemed to have arisen due to unpaid interest withholding tax (IWHT). Applying Div 974 to the arm's length conditions, the loan would give rise to a debt interest, with IWHT required to be paid.

Example 3 – Outbound interest-free loan



Apply Div 974 to	Characterisation	Result	
AC	Debt interest	No interest	No TP benefit
ALC	Equity interest	Non-assessable non-exempt (768-A)	

The third scenario involves an interest free outbound loan which satisfies the debt test in Div 974. In this scenario, the international related party is a subsidiary in the exploration stage of a mining business, and would not have been able to obtain third-party debt financing from an unrelated party.

Had the arm's length conditions operated instead of the actual conditions, AusCo would have made a capital contribution to ForCo rather than a loan. As there is no transfer pricing benefit under the arm's length conditions, Subdiv 815-B does not operate and the classification of the arrangement as a debt interest is not affected.

Observations

Div 974 was introduced to provide greater certainty to the classification of an instrument as debt or equity for tax purposes. For cross-border related party transactions, it would seem that taxpayers cannot simply rely on Div 974 in determining the treatment of the returns on financing arrangements.



The outcome from Example 2 is particularly negative and is an example of a tax trap for taxpayers. The TP benefit is derived from unpaid IWHT, however no deduction is available for any returns paid on the instrument given its characterisation as an equity interest under Div 974.



The arm's length characterisation to the outbound loans in Example 1 and Example 3 appear different. The question is whether the tax authority in the other jurisdiction would agree with Australia's view of what the arm's length conditions would be.



Take-away for multinational taxpayers

Cross-border related party loans are under the ATO's continuous scrutiny and compliance actions.

Taxpayers should always review whether their cross-border related party financing arrangements reflect arm's length conditions (which are not limited to pricing itself and could go into complex considerations such as capital structure and guarantee).

Speak with our transfer pricing specialists to find out where your risks of related party financing arrangement are and how they can be mitigated.

For more information on the ATO's Transfer Pricing Risk Assessment Framework [click here](#).

¹ These examples are for illustration purpose only, and should not be relied on as a ruling on what the arm's length conditions would be in a similar situation.



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