TAXAND

Chevron case – the wash up

The long running transfer pricing dispute between Chevron Australia Holdings Pty Ltd (**Chevron Australia**) and the Australian Commissioner of Taxation has come to an abrupt end. Having applied for special leave for the matter to be heard by the High Court (Australia's superior court), Chevron Australia announced on 15 August that it had reached a confidential settlement with the Commissioner and that it had accordingly lodged a notice of discontinuance in respect of its application.

A recap

By way of a recap, the dispute involved international related party borrowings of USD 2.45 billion advanced at the rate of 9% to Chevron Australia by its US subsidiary (Chevron Texaco Funding Corporation - **CFC**). CFC funded the loan to Chevron Australia by raising funds on the US commercial paper market at interest rates of approximately 1.2%. The effect of the interest payments made at the rate of 9% under the agreement was to create a tax deduction for Chevron Australia against its operating revenue from its interest, through subsidiaries, in the North West Shelf gas project. The interest income in the hands of CFC was not taxable in the United States. Further, because CFC was a wholly owned foreign subsidiary of Chevron Australia, the dividends declared by CFC from the profits were not assessable income in the hands of Chevron Australia for Australian tax purposes. Thus, operating 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. Also of note, the loan was unsecured, contained no financial or operational covenants and was not guaranteed. At issue was whether the interest paid by Chevron Australia to CFC exceeded the arm's length price in respect of the AUD equivalent of the borrowing. Immediately at stake was approximately AUD 340 million of primary tax, penalties and interest.

The Commissioner issued amended assessments based on determinations under the former Australian transfer pricing regime – namely Division 13 of the *Income Tax Assessment Act 1936* in respect of the 2004 to 2008 tax years and Sub-division 815-A of the *Income Tax Assessment Act 1997* in respect of the 2006 to 2008 tax years.

Chevron was unsuccessful before the Federal Court and appealed to the Full Federal Court. The Full Federal Court unanimously dismissed the appeal. Aside from other evidentiary, administrative and constitutional arguments dispensed with in the appeal, the main thrust of the decision of the Full Federal Court was that under Division 13 and Sub-division 815-A, it was necessary to construct a comparable arrangement in respect of the borrowing that would have been entered into by independent parties dealing at arm's length. The Court held that such a comparable arrangement would have included security and/or a parent company guarantee in respect of external borrowings which would in turn have a bearing on the interest rate. The corollary was that a secured and/or guaranteed loan would have been subject to a lower interest rate than that incurred by Chevron Australia under the actual conditions of the loan advanced by CFC. The Court effectively concluded that a taxpayer cannot write the terms of its loan arrangements with related parties (eg. to exclude security or a guarantee) and then determine the arm's length price according to those terms.

An abrupt end

Having been unsuccessful in the Full Federal Court, Chevron lodged an application for special leave for the matter to be heard by the High Court (Australia's superior court). However, Chevron has now announced that it has reached a confidential settlement with the Commissioner and had accordingly lodged a notice of discontinuance in respect of its application for special leave.

So what does this mean? The decision of the Full Federal Court now stands. Unfortunately, that decision relates only to the former Australian transfer pricing rules (ie. those applying in respect of income years commencing before 1 July 2013). Although there are some current disputes in relation to the former rules on foot, it would be anticipated that future matters before the Courts would relate to the current transfer pricing rules – in respect of which the Chevron Australia case provides no specific guidance. Some commentators are suggesting that the Chevron Australia decision may still be of some assistance in such matters (by way of an analogy?) but that remains to be seen.

Other developments

In terms of other developments, with a unanimous decision of the Full Federal Court in hand, the Commissioner had also been quick off the mark to release *Draft Practical Compliance Guideline PCG 2017/D4* which sets out the Commissioner's views on assessing tax risk associated with international related party financing arrangements. The PCG sets out a framework under which taxpayers can check their own financing arrangements against a risk spectrum (ranging from "white zone: arrangements already reviewed by the Australian Taxation Office", to "Red zone: very high risk"). That framework involves 11 risk indicators. The higher an arrangement falls on the risk spectrum, the more likely that the Australian Taxation Office will dedicate compliance resources to that arrangement and the higher the risk of audit and/or litigation. Interestingly, in light of the Chevron Australia case, one of the focuses of the PCG is ensuring that pricing of Australian debt is more closely aligned with the external cost of finance borne by the global parent of the multinational group ("cost of referable debt"). For example, one of the risk indicators that may see an arrangement placed in the "green zone – low risk" is where the price of the Australian debt is set at 50 basis points or less over the cost of the referable debt. However, this is only one of the risk indicators and it is also important to note that the PCG does not provide a safe-harbour for taxpayers, nor is it binding on the Commissioner (unlike a public ruling).

Further, the Foreign Investment Review Board (**FIRB**) is requesting information in relation to transfer pricing and inbound related debt consistent with the risk indicators in PCG 2017/D4.

Taxand's Take

The above developments in case law, the PCG and FIRB (together with the Australian Government's current laser like focus on multi-national tax avoidance) mean that the Commissioner is focused on transfer pricing and sees it as fertile ground for compliance activity. This means that taxpayers should be reviewing their international financing arrangements and other transfer pricing practices (those already on foot and those proposed to be entered into) carefully.